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Department of the Treasury
Internal Revenue Service

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Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

These principles of tax administration were previously published in the Internal Revenue Bulletin as Revenue Procedure 64-22, 1964-1 (Part I) C.B. 689. They are restated here to emphasize their importance to all employees of the Internal Revenue Service.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue Rulings represent the conclusions of the Service on the application of the law to the entire state of facts involved. In those that are based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and confidential information are deleted to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

Cumulative Bulletin 1976-2 is a consolidation of all items of a permanent nature published in the weekly Bulletins 1976-27 through 1976-52 for the period of July 1 through December 31, 1976. It includes a cumulative list of announcements relating to decisions of the Tax Court published in the Internal Revenue Bulletins.

The Internal Revenue Cumulative Bulletin is prepared in three parts as follows:

Part I.—1954 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1954. Arrangement is sequential according to Code and regulations sections. The Code section is shown at the top of each page.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and related Treasury Decisions and Revenue Rulings; Subpart B, Legislation and related Committee Reports.

Part III.—Administrative, Procedural and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Included in this Part is a list of persons disbarred or suspended from practice before the Internal Revenue Service.

The Bulletin Index-Digest System, a research and reference service supplementing the Bulletin, may be obtained from the Superintendent of Documents on a subscription basis. It consists of four Services: Service No. 1, Income Tax; Service No. 2, Estate and Gift Taxes; Service No. 3, Employment Taxes; Service No. 4, Excise Taxes. Each Service consists of a basic volume and a cumulative supplement that provide (1) finding lists of items published in the Bulletin, (2) digests of Revenue Rulings, Revenue Procedures, and other published items, and (3) topical indexes of Public Laws, Treasury Decisions, and Tax Conventions.

The synopses preceding Revenue Rulings, Revenue Procedures, and Court Decisions are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

The contents of this publication are not copyrighted and may be reprinted freely; a citation of the Cumulative Bulletin as the source would be appropriate.

Definition of Terms

Revenue Rulings and Revenue Procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified,* below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified,* above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1954 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified and superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A, B, C, etc.—Names of individuals.
Acq.—Acquiescence.
A.R.R.—Committee on Appeals and Review recommendation.
A.T.—Alcohol and tobacco tax ruling.
B.T.A.—Board of Tax Appeals.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
C.T.—Carriers Taxing Act of 1937.
Ct.D.—Court Decision.
Del. Order—Delegation Order.
D.C.—Treasury Department circular.
DISC—Domestic International Sales Corporations.
E.O.—Executive Order.
E.T.—Estate and gift tax ruling.
Em. T.—Employment tax ruling.
F.A.A.A.—Federal Alcohol Administration Act.
FICA—Federal Insurance Contributions Act.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
G.C.M.—Chief Counsel's memorandum (formerly General Counsel's memorandum).
I.R.B.—Internal Revenue Bulletin.
IR-Mim. — Published IR-Mimeograph.
I.T.—Income tax ruling.
M, N, X, Y, Z, etc.—Names of corporations, places or businesses, according to context.
M.T.—Miscellaneous tax ruling.
Mim.—Published mimeograph.
Nonacq.—Nonacquiescence.
O.D.—Office Decision.
P.T.E.—Prohibited Transactions Exemption.
Pub.L.—Public Law.
PS—Pension, profit-sharing, stock bonus or annuity plan ruling.
R.E.I.T.—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
R.S.—Revised Statute.
S.M.—Solicitor's Memorandum.
Sol. Op.—Solicitor's Opinion.
S.P.R.—Statement of Procedural Rules.
S.R.—Solicitor's Recommendation.
S.S.T.—Social Security Tax.
S.T.—Sales tax ruling.
Stat.—Statutes at Large.
T.C.—Tax Court.
T.D.—Treasury Decision.
T.I.R.—Technical Information Release.
U.S.C.—United States Code.
x and *y* represent numbers and sums of money.

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It is the policy of the Internal Revenue Service to announce in the Internal Revenue Bulletin at the earliest practicable date the determination of the Commissioner to acquiesce or not acquiesce in a decision of the Tax Court which disallows a deficiency in tax determined by the Commissioner to be due.

Notice that the Commissioner has acquiesced or nonacquiesced in a decision of the Tax Court relates only to the issue or issues decided adversely to the Government.

Actions of acquiescences in adverse decisions shall be relied on by Revenue officers and others concerned as conclusions of the Service only to the application of the law to the facts in the particular case. Caution should be exercised in extending the application of the decision to a similar case unless the facts and circumstances are substantially the same, and consideration should be given to the effect of new legislation, regulations, and rulings as well as subsequent court decisions and actions thereon.

Acquiescence in a decision means acceptance by the Service of the conclusion reached, and does not necessarily mean acceptance and approval of any or all of the reasons assigned by the Court for its conclusions.

No announcements are made in the Bulletin with respect to memorandum opinions of the Tax Court.

The announcements published in the weekly Internal Revenue Bulletins are consolidated semiannually and annually. The semiannual consolidation appears in the first Bulletin for July and in the Cumulative Bulletin for the first half of the year and the annual consolidation appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

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[4] United States Board of Tax Appeals.

[1] Acquiescence published in 1946-1 C.B. 1, is withdrawn and acquiescence in result is substituted. (See footnote 4)

[2] Estate Tax decision.

[3] Acquiescence in result in the issue relating to whether the proceeds of an insurance policy on the decedent's life are includible in the gross estate because the community property interest under the laws of Louisiana extended either to the proceeds of the policy or to the incidents of ownership in the policy. (See footnote 4)

[4] Acquiescence in result. Acquiescence "in result" means acceptance of the decision of the Court but disagreement with some or all the reasons assigned for the decision.

[5] Acquiescence in result in the issue relating to the fair market value of charitable contributions. (See footnote 4)

[6] Acquiescence in issue No. 1 relating to whether Lewisville Investment Co. was organized for the principal purpose of evasion or avoidance of Federal income tax.

[7] Acquiescence in the issue relating to whether funds deposited into an escrow account was boot or a loan.

[8] Acquiescence in result in the issue relating to whether advances made by California Business Service & Audit Co. constituted constructive dividends to petitioner or bona fide loans. (See footnote 4)

[9] Acquiescence relates to the issue pertaining to the Federal income tax treatment of maintenance expenses where a residence is held by a trust for use by the life beneficiary. Nonacquiescence published in XIII-2 (1934) C.B. 33, withdrawn.

[10] Originally published in 1970-2 C.B. xxi, with footnote number incorrectly designated. The designation should have been to footnote 13 on page xxiii of C.B. 1970-2, which reads substantially as follows:

[13] Acquiescence in the issues relating to whether (1) the taxpayer was a member of a joint venture in respect of the championship prize fight and taxable on his distributable share of the proceeds; (2) the contract providing for deferred payment was a sham; (3) expenditure for fight tickets was a deductible business expense; and (4) claimed expenditures for training camp facilities were deductible. Acquiescence in result only in the issue relating to whether service of a Notice of Levy prevented petitioner's realization of income in the taxable year ending on the date of the fight, or, in any event, in the 1957 calendar taxable year. See Rev. Rul. 70-435, 1970-2 C.B. 100.

[11] See Rev. Rul. 76-411, page 208, this Bulletin.

[12] Acquiescence published in 1974-2 C.B. 4 is withdrawn and acquiescence in result is substituted. (See footnote 4) See Rev. Rul. 76-484, page 185, this Bulletin.

[13] Acquiescence in the issue relating to whether the decedent on the date of death owned a contract right which entitled her to collect $234.25 in accrued interest from her grandson.

[14] Gift Tax decision.

[15] Acquiescence published in 1961-2 C.B. 3, is withdrawn and nonacquiescence is substituted therefor.

[16] See Rev. Rul. 76-316, page 22, this Bulletin.

[17] Nonacquiescence in issue No. 2 relating to whether the amounts paid by Lewisville to certain of its stockholders were reasonable compensation for their services.

[18] Nonacquiescence in the issue relating to whether the transaction between petitioner and Firemen's Insurance Co. of New Jersey represents a sale of an option or an exchange of properties.

[19] Acquiescence published in 1962-2 C.B. 5, is withdrawn and nonacquiescence is substituted therefor.

[20] Acquiescence published in 1952-2 C.B. 3, is withdrawn and nonacquiescence is substituted.

[21] Nonacquiescence in the issue relating to whether the gift of the funds in a savings account by the decedent to her daughter was made in contemplation of death.

[22] Acquiescence in issue No. 1 relating to whether withdrawals made by the decedent's wife from a joint checking account with decedent constituted transfers in contemplation of death published in 1976-1 C.B. 1 is withdrawn and acquiescence in result is substituted. (See footnote 4)

Part I. Rulings and Decisions Under the Internal Revenue Code of 1954

Subpart A.—Income Taxes
Chapter 1.—Normal Taxes and Surtaxes
Subchapter A.—Determination of Tax Liability
Part I.—Tax on Individuals

Section 2.—Definitions and Special Rules

Date of death, for members of the Armed Forces of the United States or civilian employees who are prisoners of war or missing in action, for purposes of determining spouse's status as a "surviving spouse" under section 2(a) of the Code. See Rev. Rul. 76-468, page 202.

Part II.—Tax on Corporations

Section 11.—Tax Imposed

26 CFR 1.11-1: Tax on corporations.

Whether a mutual savings bank that conducts a life insurance business in a separate department is entitled to compute the alternative tax for such organizations under section 594 of the Code, utilizing the surtax exemptions under section 11(d) in determining both the partial tax on the income of the insurance department and the partial tax on the income of the banking department, before adding the two partial taxes to determine the overall tax under section 594. See Rev. Rul. 76-476, page 184.

Part IV.—Credits Against Tax
Subpart A.—Credits Allowable

Section 37.—Credit for the Elderly

26 CFR 1.37-2: Eligibility for retirement income credit.
(Also Section 911; 1.911-1, 1.911-2.)

Retirement income credit; earned income; resident alien. Compensation received for personal services rendered in a foreign country by a citizen resident of that country who later became a U.S. resident is earned income for purposes of the retirement income credit.

Rev. Rul. 76-295

Advice has been requested whether compensation received for personal services rendered in a foreign country by a citizen and resident of that country who later became a United States resident is "earned income" for purposes of the retirement income credit provided by section 37 of the Internal Revenue Code of 1954.

Under subsections (a) and (b) of section 37 of the Code, an individual who has received more than $600 of earned income, as defined in section 37(g), in each of any 10 calendar years before the taxable year, shall be allowed as a credit against Federal income tax for the taxable year an amount computed by reference to the individual's retirement income.

Section 37(g) of the Code provides, in part, that for the purposes of section 37(b), the term earned income has the meaning assigned to that term by section 911(b), except that the term does not include any amount received as a pension or annuity.

Section 911(b) of the Code provides, in general, that the term earned income means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered.

The work-qualifying requirement of section 37(b) of the Code (that is, the requirement that, in order to be eligible for the retirement income credit, the individual must have received earned income in excess of $600 in each of any 10 calendar years before the taxable year) is interpreted by section 1.37-2 of the Income Tax Regulations.

Section 1.37-2(c) of the regulations provides, in part, that the 10 calendar years need not immediately precede the taxable year, need not be consecutive, and need not include years subject to the income tax laws. It further provides that the 10 calendar years may include years for which the taxpayer was exempt from income tax, and may include years for which the taxpayer was not required to file an income tax return or had no income subject to tax as, for example, a calendar year during which the individual's income was less than the personal exemption, or a calendar year for which the individual's earned income was excluded from gross income under section 911(a).

These regulations contemplate that the work-qualifying requirement of section 37(b) of the Code will be met for a year when all or part of the individual's income was exempt from tax for whatever reason, and, thus, encompass situations where the income was exempt from tax because it was earned in a foreign country by a citizen of that country who was not a United States resident subject to the United States income tax laws.

Accordingly, compensation received for personal services rendered in a foreign country by a citizen and resident of that country who later became a United States resident is earned income for purposes of the retirement income credit provided by section 37 of the Code.

Section 38.—Investment in Certain Depreciable Property

26 CFR 1.38-1: Investment in certain depreciable property.
(Also Sections 46, 48, 1381; 1.46-4, 1.48-1, 1.1381-1.)

Investment credit; section 38 property leased to nonexempt cooperative. Neither section 46(e)(1)(C) nor section 48(a)(4) of the Code will apply to limit or deny the amount of qualified investment credit that a corporate lessor may claim on section 38 property that it leases to a nonexempt cooperative organization described in section 1381(a)(2).

Rev. Rul. 76-260

Advice has been requested whether, under the circumstances described below, either section 46(e)(1)(C) or section 48(a)(4) of the Internal Revenue Code of 1954 is applicable to a corporate lessor that leases property

to a cooperative organization described in section 1381(a)(2).

In 1975, *M*, a domestic corporation, purchased equipment that qualifies as section 38 property within the meaning of section 48(a) of the Code and, thereby, was eligible for the investment credit under section 38. The equipment had a useful life of 20 years to *M*. *M* leased the equipment to *X*, a non-exempt cooperative organization within the meaning of section 1381(a)(2) for a period of 15 years. *M* has not elected, under section 48(d)(1), to treat *X* as having purchased the equipment.

Section 38 of the Code allows taxpayers a credit against Federal income tax in an amount permitted by section 46 for the qualified investment in depreciable property described in section 48. Under section 46(c)(1), a qualified investment arises only with respect to "new" or "used" section 38 property placed in service during the year.

In general, the maximum investment credit allowed for a taxable year is limited to $25,000 plus 50 percent of the taxpayer's tax liability in excess of $25,000.

However, section 46(e)(1)(C) of the Code and section 1.46-4(c)(1) of the Income Tax Regulations provide, in part, that in the case of a cooperative organization described in section 1381(a), the qualified investment with respect to each item of section 38 property otherwise determined under section 1.46-3 and the $25,000 amount specified in section 46(a)(2), relating to the limitation based on amount of tax liability, shall be reduced to such cooperative's ratable share of each such amount.

In addition, section 48(a)(4) of the Code provides, in general, that property used by an organization (other than a cooperative described in section 521) that is exempt from the tax imposed by chapter 1 of the Code shall not be treated as section 38 property, unless such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511.

The limitation provided in section 48(a)(4) of the Code applies to the user of the property; whereas, the limitation provided in section 46(e)(1)(C) applies to the owner of the property. In addition, the limitation provided in section 48(a)(4) applies only to tax exempt organizations, other than farmers' cooperatives exempt from tax under section 521.

In the instant case, *M* and not *X* is the owner of the property. Therefore, inasmuch as the reduction in the amount of qualified investment in section 38 property provided in section 46(e)(1)(C) of the Code applies only where such property is owned by a cooperative organization described in section 1381(a), that limitation does not apply to reduce *M*'s qualified investment in the equipment. In addition, inasmuch as the property is not being used by a tax-exempt organization, section 48(a)(4) is not applicable.

Accordingly, *M*, may claim the investment credit on the purchase of the equipment under section 38 of the Code and neither the limitation on the credit provided in section 46(e)(1)(C) nor the denial of the credit provided in section 48(a)(4) will apply.

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26 CFR 1.38-1: Investment in certain depreciable property.

Whether the Service will issue advance rulings that certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes when the property is "limited use property." See Rev. Proc. 76-30, page 647.

Section 44.—Purchase of New Principal Residence

26 CFR 1.44-2: Property to which credit for purchase of new principal residence applies.

Housing credit; self-constructed new principal residence. The proper method is shown for computing the housing credit for purchase of a self-constructed new principal residence that was occupied by a taxpayer in either 1975 or 1976 and constructed partly in 1975 and partly in 1976.

Rev. Rul. 76-512

Advice has been requested concerning the application of section 44 of the Internal Revenue Code of 1954 relating to the housing credit, under the circumstances described below.

The taxpayer, who is a single individual and files Federal income tax returns on the basis of a calendar year, self-constructed a principal residence. Construction commenced March 17, 1975, and was completed May 4, 1976. The portion of the residence constructed in 1975 cost $30,000 and the portion constructed in 1976 cost $15,000.

The taxpayer occupied the principal residence as of December 1, 1975, and qualified for the housing credit. The taxpayer's Federal income tax liability against which the housing credit could be applied was $2,100 in 1975 and $400 in 1976.

Specific advice has been requested concerning when the credit may be taken by the taxpayer and what limitation, as to amount, is imposed by section 44(b)(5) of the Code.

Section 44(a) of the Code provides that in the case of an individual there is allowed (subject to limitations) as a credit against the tax imposed by chapter 1 of the Code, for the taxable year, an amount equal to 5 percent of the purchase price of a new principal residence purchased or constructed by the taxpayer.

Section 44(b)(1) of the Code provides that the credit may not exceed $2,000 ($1,000 for a married individual filing a separate return).

Section 44(b)(5) of the Code provides that the credit may not exceed the amount of tax imposed by chapter 1 for the taxable year, reduced by the

sum of credits allowable under specified other Code sections.

Section 1.44-2(d) of the Income Tax Regulations provides, in part, that a self-constructed residence must be occupied by the taxpayer before January 1, 1977. Further, where self-construction of a principal residence was begun before March 13, 1975, only that portion of the basis of the property allocable to construction after March 12, 1975, and before January 1, 1977, will be taken into consideration in determining the amount of the credit allowable.

The above general rules require, in the case of a self-constructed residence, that the taxpayer occupy the residence before January 1, 1977. There is no acquisition requirement as there is in the case of a purchased residence, since in the case of self-construction, there is no specific date of acquisition but rather multiple purchase dates of construction supplies during the period of construction. The general rules provide that the basis of the property allocable to construction after March 12, 1975, and before January 1, 1977, will be taken into consideration in determining the amount of credit available. By occupying the residence in 1975 and incurring construction costs in that year, the taxpayer qualified for the housing credit in that year subject to the limitations of sections 44(b)(1) and 44(b)(5) of the Code. The credit stemming from the 1975 construction costs must be reflected on the taxpayer's 1975 Federal income tax return or be forfeited. If the 1975 credit is less than both the taxpayer's 1975 Federal income tax liability and $2,000, the taxpayer will qualify for a credit in 1976 based on construction costs incurred in that year. However, the amount of credit reflected in 1976 may not exceed the taxpayer's 1976 Federal income tax liability. Furthermore, the combined total of 1975 and 1976 credits may not exceed the lesser of taxpayer's 1975 Federal income tax liability or $2,000.

Accordingly, since the taxpayer, in the present case, occupied the residence and became entitled to the credit in 1975, the taxpayer's housing credit for 1975 is $1,500 (5% × $30,000) since this amount is less than either the $2,000 maximum limit or the taxpayer's 1975 Federal income tax liability. In 1976, the taxpayer's available housing credit is $750 (5% × $15,000) but that amount is limited to $400 since the taxpayer's 1976 Federal income tax liability is $400. If the taxpayer's 1976 liability had been $500 or more, the taxpayer could have reflected a housing credit of $500 ($2,000 maximum allowed less $1,500 taken or forfeited in 1975). However, if the taxpayer did not occupy the residence until 1976, he would not be entitled to a housing credit for 1975, and, in 1976, the taxpayer's available housing credit would be $400 (5% × $45,000 reduced to the lessor of $2,000 (maximum limit) or $400 (income tax liability for 1976)).

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26 CFR 1.44-4: Recapture for certain dispositions.

Rev. Rul. 76-513

In April, 1975, the taxpayer acquired and occupied a new principal residence. In all respects, the transaction entitled the taxpayer to a housing credit pursuant to section 44 of the Internal Revenue Code of 1954. The taxpayer properly applied the credit to the taxpayer's income tax liability reflected on the 1975 Federal Income Tax Return (Form 1040) filed in March, 1976.

In June, 1976, the taxpayer was transferred to a temporary work site and rented the new principal residence while absent.

Held, the renting of the new principal residence after the taxpayer acquired and occupied it did not result in a disposition of the new principal residence within the meaning of section 44(d) of the Code. Therefore, the taxpayer is not required, under section 44 to recapture the housing credit taken for 1975.

Subpart B.—Rules for Computing Credit for Investment in Certain Depreciable Property

Section 46.—Amount of Credit

26 CFR 1.46-1: Determination of amount.

Procedure for applying interim rules governing employee stock ownership plans under section 301(d) of the Tax Reduction Act of 1975 pending the issuance of final rules and regulations. See Rev. Proc. 76-31, page 649.

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26 CFR 1.46-3: Qualified investment. (Also Section 48; 1.48-1.)

Investment credit; liquefied natural gas facility. A liquefied natural gas (LNG) facility consisting of depreciable property having a useful life of 3 or more years, including a short section of pipeline spur, LNG machinery and equipment, and an LNG storage tank, constructed after August 15, 1971, and before January 22, 1975, by an intrastate utility engaged in both the transmission and local distribution of gas for the purpose of liquefying and storing natural gas for subsequent vaporization and distribution, is public utility property for investment credit purposes.

Rev. Rul. 76-268[1]

Advice has been requested, under the circumstances described below, whether a liquefied natural gas (LNG) facility is public utility property within the definition of section 1.46-3(g) of the Income Tax Regulations for investment credit purposes.

The taxpayer is an intrastate rate-regulated gas utility, subject to the regulatory jurisdiction of the state public service commission, that operates 2,500 miles of gas distribution lines. The taxpayer operates an LNG

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[1] Also released as IR-1627, dated June 25, 1976.

facility, with a pressure range in excess of 125 pounds per square inch gauge (psig), within its distribution area consisting of the following components: (1) a short section of pipeline spur that connects the LNG facility with a 50-mile pipeline that the taxpayer operates for the benefit of itself and two co-owning distribution utilities to which it sells gas (The 50-mile pipeline connects an interstate gas transmission supply pipeline with the point of entry into the taxpayer's distribution system proper, and with the LNG facility); (2) LNG machinery and equipment; and (3) an LNG storage tank.

The LNG facility liquefies and stores excess natural gas, received in off-peak periods, for subsequent vaporization and distribution through the local distribution area.

The LNG facility was constructed and placed in service by the taxpayer after August 15, 1971, and before January 22, 1975, and is depreciable property having a useful life of 3 years or more.

Section 38 of the Internal Revenue Code of 1954 allows a credit against Federal income tax for qualified investment in section 38 property. The determination of what property qualifies as section 38 property is made in accordance with the rules provided in section 48.

Section 48(a)(1) of the Code provides, in part, that the term "section 38 property" means tangible personal property, or other tangible property (not including a building and its structural components) but only if the other tangible property is used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or constitutes a research or storage facility used in connection with any of the foregoing activities. To qualify as "section 38 property," the property must also be property with respect to which depreciation is allowable and must have a useful life of 3 years or more.

In the case of public utility property, section 46(c)(3)(A) of the Code limits the amount of the qualified investment to 4/7 of the amount determined under section 46(c)(1). For this purpose, section 46(c)(3)(B)(ii) defines "public utility property" to include property used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system.

Section 1.46-3(g)(4)(i) of the regulations provides, in part, that with respect to properties of a taxpayer engaged in both the transmission of gas and the local distribution of gas, section 38 property shall be considered as used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system if expenditures for such property are chargeable (or would be chargeable) to accounts 360 through 363, inclusive, (Local Storage Plant) of the Uniform System of Accounts prescribed by the Federal Power Commission (F.P.C.) for natural gas companies, effective January 1, 1961.

These four accounts effective January 1, 1961, are described as follows: Account 360 includes the cost of land and land rights used in connection with local storage of gas in holders within or adjacent to distribution areas. Account 361 includes the cost, in place, of structures and improvements used in connection with local storage of gas within or adjacent to distribution areas. Account 362 includes the cost installed of holders and associated appliances used in the storage of gas above ground or in underground receptacles installed for local storage purposes, and provides that the cost of holders of LNG are to be included in a sub-account of 362. Account 363 includes the cost installed of other equipment used in connection with the storage of gas within or adjacent to distribution areas. (The revision of 18 CFR, effective April 1, 1974, designates Accounts 360, 361, 362, 363, 363.1, 363.2, 363.3, 363.4 and 363.5 as Other Storage Plant accounts, rather than as Local Storage Plant accounts. Section 1.46-3(g)(4)(i) of the regulations is predicated on the account descriptions effective January 1, 1961.)

The use of the taxpayer's LNG facility for liquefaction and storage of excess natural gas, received in off-peak demand periods, for subsequent vaporization and distribution through a system within the local distribution area during peak demand periods is identical to that of an LNG gas holder as mentioned in the F.P.C. local storage plant account 362 description, effective January 1, 1961. Therefore, since F.P.C. account 362 description provides that the cost of holders of LNG are to be included in a sub-account of 362, and section 1.46-3(g)(4)(i) of the regulations provides that when costs of property are chargeable to F.P.C. account 362, such property shall be considered as used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system, such property as the LNG facility is public utility property within the definition of section 1.46-3(g).

Accordingly, the taxpayer's LNG facility, if otherwise qualified, is public utility property within the definition of section 1.46-3(g) of the regulations and entitled to an investment credit allowance of 4/7 of the amount otherwise determined under section 46 of the Code. This eligibility is applicable to the short section of pipeline spur, the LNG machinery and equipment, and the LNG storage tank.

See section 301(a) of the Tax Reduction Act of 1975, which allows higher investment credits for property that is constructed, reconstructed, or erected, and placed in service after January 21, 1975, and before January 1, 1977.

26 CFR 1.46-3: Qualified investment.

Investment credit; railroad communications equipment. Communications equipment of the type used by regulated telephone and microwave communications companies, acquired and placed in service in 1973 by a railroad corporation to service passenger and freight train movements and other types of company communications, is public utility property within the meaning of section 46(c)(3) of the Code and qualifies for a four percent investment tax credit.

Rev. Rul. 76-436

Advice has been requested whether communication equipment that a taxpayer acquired and placed in service in 1973 is "public utility property" within the meaning of section 46(c)(3) of the Internal Revenue Code of 1954 as in effect in 1973.

In 1973 the taxpayer, a railroad corporation, acquired and placed in service the following property used for communication purposes: microwave equipment, private communication equipment, data transmission equipment, communication terminal equipment connected to a public utility telephone company, and other related communication equipment. This equipment services passenger and freight train movements as well as other types of company communications.

This property is used predominately for communication purposes and is of the type used by regulated telephone and microwave communications companies. Although the taxpayer is in the railroad transportation business, which is regulated by the Interstate Commerce Commission and state regulatory agencies, property of railroads generally is not considered regulated public utility property within the meaning of section 46(c)(3) of the Code.

All of the communication property considered in this Revenue Ruling is depreciable tangible personal property with useful lives in excess of 3 years.

Section 38 of the Code allows a credit against Federal income tax for qualified investment in "section 38 property." The determination of the proper amount of investment credit for qualified section 38 property is made in accordance with the rules provided in section 46.

Section 46(c)(3)(A) of the Code is in effect in 1973 provided that in the case of section 38 property that is public utility property, the amount of the qualified investment is 4/7 of the amount determined under section 46(c)(1).

Section 46(c)(3)(B)(iii) of the Code provides, in part, that the term "public utility property" means property used predominately in the trade or business of furnishing or sale of telephone service, telegraph service by means of domestic telegraph operations, or other communication services, if the rates for such furnishing or sale are established or approved by a Federal or state government agency. Also, section 46(c)(3)(B) provides that the term "public utility property" means communication property of the type used by persons engaged in providing telephone or microwave communication services to which section 46(c)(3)(B)(iii) applies, if such property is used predominately for communication purposes.

The report of the Senate Committee on Finance considering the Revenue Act of 1971, *S. Rep. No.* 92-437, 92nd Cong., 1st Sess. 37 (1971), 1972-1 C.B. 559, 579, states, in part, that the committee was impressed by the trend among unregulated businesses to install their own communications equipment rather than equipment made available by regulated companies. The Committee concluded that, in order to avoid having the investment credit create an improper discrimination in competition by restricting public utilities to 4 percent investment credit on their property and allowing other taxpayers 7 percent investment credit on the same type of property used for the same purposes, it was necessary to equalize the rates of investment tax credit available to the competitors. As a result, the committee decided to limit to 4 percent the credit for communications property of the type used by regulated telephone and microwave communications companies if the property is used predominantly for communication purposes. The committee intended this limitation to apply to microwave transmission equipment, private communications equipment, private switchboard equipment, communications terminal equipment connected to telephone networks, data transmission equipment, and communications satellites, but such limitation would not apply to computer terminals or facsimile reproduction equipment that is connected to telephone lines to transmit data.

The communication property in the instant case is of the type used by regulated telephone and microwave communications companies, and such property is used by the taxpayer predominantly for communication purposes as provided in section 46(c)(3) of the Code.

Section 46(c)(3) of the Code reflects the intention of Congress to be indiscriminate by including as "public utility property" the same type of communications property used for the same purposes by taxpayers other than public utilities. While the taxpayer in the instant case is in the railroad business, which is regulated by the Interstate Commerce Commission and state regulatory agencies, this fact has no bearing upon the classification of its communications property as "public utility property" under section 46(c)(3).

Accordingly, the communications equipment that the taxpayer acquired and placed in service in 1973 is "public utility property" within the meaning of section 46(c)(3) of the Code. Therefore, in 1973 the amount of the qualified investment is 4/7 of the

amount determined under section 46 (c). However, it is noted that, under section 46(a)(1)(D), as amended by section 802(a) of the Tax Reform Act of 1976, [1976-2 C.B.] qualified section 38 property acquired after January 21, 1975, and before January 1, 1981, and placed in service before January 1, 1981, is eligible for 10 percent investment tax credit whether or not it is "public utility property."

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26 CFR 1.46-3: Qualified investment.

The determination of the "first placed in service" date for a coal fired electric generating facility. See Rev. Rul. 76-256, page 46.

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26 CFR 1.46-3: Qualified investment.

The determination of the "first placed in service" date for a nuclear electric generating unit. See Rev. Rul. 76-428, page 47.

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26 CFR 1.46-3: Qualified investment.

Whether investment tax credit is allowable to a taxpayer for costs of labor and material incident to the installation of depreciable assets prior to 1974, when the taxpayer voluntarily requested, in accordance with sections 446 and 481 of the Code, a change in method of accounting from deducting installation costs to capitalizing installation costs beginning with taxable year 1974. See Rev. Rul. 76-437, page 12.

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26 CFR 1.46-4: Limitations with respect to certain persons.

Investment credit; aggregation of lease terms. A lease of a new tractor by a noncorporate lessor to a domestic corporation, with no option to renew, for a term less than 50 percent of its useful life is not required to be aggregated, under section 46(e)(3)(B) of the Code, with a lease provided either by a concurrent agreement that at the expiration of the lease term the lessee would lease another new tractor for a similar term or by negotiations at the expiration of the lease term resulting in leasing the same tractor for an identical term. However, a concurrent agreement with the corporation's subsidiary that, at the end of the lease term, it would lease the same tractor for an identical term requires the leases to be aggregated.

Rev. Rul. 76-266

Advice has been requested whether, in the situations described below, leases of property by a noncorporate lessor are required to be aggregated for purposes of the "less than 50 percent of the useful life" test of section 46(e)(3)(B) of the Internal Revenue Code of 1954.

Situation 1

In January 1974, *P*, a general partnership, leased a new tractor to *X*, a domestic corporation, for a term of less than 50 percent of the estimated useful life of the tractor. The lease contained no option to renew. At the same time, *P* and *X* agreed that upon expiration of the term of the first lease *X* would lease from *P* another new tractor with comparable specifications. This second lease was for a term of less than 50 percent of the estimated useful life of the tractor.

Situation 2

In January 1974, *P*, a general partnership, leased a new tractor to *X*, a domestic corporation, for a term of less than 50 percent of the estimated useful life of the tractor. The lease contained no option to renew. At the expiration of the term of that lease, *P* entered into negotiations with *X* that resulted in *P*'s leasing to *X* the same tractor for a second identical term.

Situation 3

In January 1974, *P*, a general partnership, leased a new tractor to *X*, a domestic corporation, for a term of less than 50 percent of the estimated useful life of the tractor. The lease contained no option to renew. At the same time, *P* entered into an agreement with *Y* Corporation, a subsidiary of *X*, under which agreement *Y* would lease from *P* a used tractor, delivery of such used tractor to occur, and the term of the lease to commence, upon the expiration of the term of the lease between *P* and *X*. The lease is for an identical term and provides that *P* shall deliver to *Y* the same tractor that *P* leased to *X*, or one in comparable condition with comparable specifications.

Section 38 of the Code allows a credit against Federal income tax for qualified investments in "section 38 property".

Section 46(e) of the Code limits the extent to which the credit allowed by section 38 is available to certain persons.

Section 46(e)(3) of the Code provides, in part, that with respect to leased property, a credit shall be allowed under section 38 to a noncorporate lessor of such property only if (A) the property subject to the lease has been manufactured or produced by the lessor; or (B) the term of the lease (taking into account any options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property that are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

The specific question is whether the term of the leases involved is less than 50 percent of the estimated useful life of the property.

Section 1.46-4(d)(4) of the Income Tax Regulations provides, in part, that if a noncorporate lessor enters into two or more successive leases with respect to the same or substantially similar items of section 38 property, the terms of such leases shall be aggregated and such leases shall be considered one lease for the purpose of determining whether the term of such leases is less than 50 percent of the

estimated useful life of the property subject to such leases. Thus, for example, if an individual owns an airplane with an estimated useful life of 7 years and enters into three successive 3-year leases of such airplane, such leases will be considered to be one lease for a term of nine years for the purpose of determining whether the term of the lease is less than 3½ years (50 percent of the 7-year estimated useful life).

With respect to the limitations set forth in section 46(e)(3) of the Code, Congress intended to deny the investment credit to noncorporate lessors in mere investment or financing situations by limiting the availability of the credit to those situations in which the lessor retains the risks and obligations typically associated with the transaction of an active business. The credit was intended to be allowed with respect to the property leased for terms that are short in comparison to the useful life of the property because the lessor thereby retains active business risks, rather than solely passive financing risks, with respect to the predominant portion of the useful life of the property. *See H.R. Rep. No. 92-533,* 92d Cong., 1st Sess. 29 (1971), 1972-1 C.B. 498, 513. Accordingly, the following conclusions are reached:

In *Situation 1,* there are two separate leases each for less than 50 percent of the estimated useful life of the property subject to each lease the terms of which need not be aggregated and treated as one lease for purposes of section 46(e)(3)(B) of the Code. Whether the property subject to one lease is "substantially similar" to the property subject to a successive lease must be determined at the termination of the first lease and the commencement of the second lease. At such time the "new" tractor that is subject to the second lease is not "substantially similar" to the "used" tractor subject to the first lease within the meaning of section 1.46-4(d)(4) of the regulations.

In *Situation 2,* although the property that is the subject of the successive leases is the same, the leases are separate and the terms of the leases need not be aggregated and treated as one lease for purposes of section 46(e)(3)(B) of the Code. Because the leases were not interrelated and were independently negotiated, the lessor retained after execution of the first lease the normal active business risks with respect to the predominant portion of the useful life of the property.

In *Situation 3,* at the expiration of the first lease and the commencement of the second lease the property subject to the two leases was "substantially similar" (i.e., a used tractor of identical specifications) within the meaning of section 1.46-4(d)(4) of the regulations. Further, the two leases were interrelated and were not independently negotiated, so that upon the execution of what was, in substance, a single agreement, the lessor did not retain the active business risks with respect to a predominant part of the useful life of the property.

Therefore, the terms of the leases involved in Situation 3 must be aggregated and treated as one lease for purposes of determining whether the lease exceeds 50 percent of the useful life of the property within the meaning of section 46(e)(3)(B) of the Code.

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26 CFR 1.46-4: Limitations with respect to certain persons.

Whether the limitation on the amount of investment credit with respect to a cooperative organization described in section 1381(a) of the Code applies to a corporation that leases "section 38 property" to a nonexempt cooperative organization. See Rev. Rul. 76-260, page 5.

Section 47.—Certain Dispositions, etc., of Section 38 Property

26 CFR 1.47-3: Exceptions to application of section 1.47-1.
(Also Section 351; 1.351-1.)

Investment credit; recapture; transfer of assets to new corporation. A taxpayer who incorporates a sole proprietorship dental practice, transferring to the newly formed corporation the dental and office equipment and retaining and leasing to the corporation a building devoted exclusively to housing the dental practice, has not merely changed the form of conducting the business, and the section 38 property transferred to the corporation ceases to be section 38 property with respect to the taxpayer.

Rev. Rul. 76-514

Advice has been requested concerning the application of section 47(b) of the Internal Revenue Code of 1954 to property transferred by an individual to a corporation under the circumstances described below.

The taxpayer, *A*, was engaged in the practice of dentistry. *A* owned dental and office equipment and a building that was devoted exclusively to housing the dental practice.

In the taxable year 1973, *A* incorporated the dental practice. The dental and office equipment that was necessary to the conduct of the dental practice, which had an adjusted basis and fair market value of approximately 70*x* dollars, was exchanged for stock in the corporation in a transaction that qualified as a nontaxable exchange under section 351 of the Code. *A* leased the building, which had an adjusted basis and fair market value of approximately 30*x* dollars, to the corporation on an annual basis for its fair rental value. Certain items of the dental and office equipment that had qualified for the investment credit were transferred prior to the close of the useful life given such assets in computing the credit under section 38. Following the exchange, *A* was in control of the corporation and retained and used the transferred section 38 property in the incorporated dental practice. The question presented is whether such transfer qualifies under the conditions set forth in section

1.47-3(f)(1)(ii)(*c*) of the Income Tax Regulations as a "mere change in the form" of doing business to which section 47(a)(1) does not apply.

Section 47(a)(1) of the Code provides, in part, that if any property is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer before the close of the useful life on which the credit under section 38 was computed, the Federal income tax shall be adjusted accordingly for the taxable year in which the "cessation" took place.

Section 47(b) of the Code provides that property shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.

Section 1.47-3(f)(1)(ii) of the regulations provides the following four mandatory criteria for determining whether, under section 47(b) of the Code, there has been a mere change in the form of conducting the trade or business:

(a) the section 38 property is retained as section 38 property in the same trade or business;

(b) the transferor of such section 38 property retains a substantial interest in such trade or business;

(c) substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred to the transferee to whom such section 38 property is transferred; and

(d) the basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor.

Before these criteria may be applied to a particular transaction, it is necessary to determine what trade or business, or trades or businesses, the taxpayer is conducting. In the present case, the taxpayer is conducting a single trade or business relating to the practice of dentistry. The building in which that business is housed is part of the dental practice and not part of a separate trade or business. *Compare* examples (2), (3), and (4) of section 1.355-1(d) of the regulations.

Criteria (*a*), (*b*), and (*d*) of section 1.47-3(f)(1)(ii) of the regulations are satisfied in the present case; however, since the transferor has retained the building that houses the dental practice, it is necessary to determine whether criterion (*c*), which requires the transfer of substantially all the assets necessary to operate the trade or business, has been satisfied.

The term "substantially all" is defined in various court cases as a relative term, dependent on the facts of any given situation. What might in one case constitute substantially all property, might be a small part of the total property involved in another case. See *R&J Furniture Co.*, 20 T.C. 857 (1953), *rev'd* on another ground, 221 F. 2d 795 (6th Cir. 1955), and *Dixie Portland Flour Company*, 31 T.C. 641 (1958), which relied on *Daily Telegram Co.*, 34 B.T.A. 101, 105 (1936). Likewise, the determination of the assets necessary to operate a trade or business is dependent on the facts of any given situation.

The facts that exist in a particular situation must be examined before and after the transfer of property in that case. For instance, in some cases a taxpayer may not own or have a long-term lease on the building housing the dental practice, so that the dental and office equipment would be substantially all of the assets of the trade or business. However, in the instant case, the taxpayer does own the building. The building is a part of the taxpayer's individual dental practice and is necessary in order to operate the incorporated dental practice in the same manner as before the transfer.

Furthermore, since the value of the building in the instant case was 30 percent of the total value of all of the assets in the taxpayer's dental practice prior to incorporation, based on a quantitative approach, it cannot be said that substantially all of the assets necessary to operate the dental practice were transferred to the corporation.

Therefore, the criterion set forth in section 1.47-3(f)(1)(ii)(*c*) of the regulations was not met in the instant case and the transfer of assets was not a mere change in the form of conducting the trade or business.

Accordingly, in the instant case, section 47(b) of the Code is not applicable, the section 38 property transferred to the corporation ceases to be section 38 property with respect to *A*, and the Federal income tax shall be adjusted accordingly for the taxable year 1973, the year in which the "cessation" took place.

Section 48.—Definitions; Special Rules

26 CFR 1.48-1: Definitions of section 38 property.
(Also Sections 46, 446, 481; 1.46-3, 1.446-1, 1.481-1.)

Investment credit; installation costs; allowability prior to year of accounting change. The lessor of electronic equipment, who in prior years deducted the cost of labor and materials with respect to the installation of the equipment and who in the current year received permission under section 446 of the Code to capitalize these items and recover the cost through depreciation, is precluded by the limitation imposed by section 481(a)(2) from claiming the investment tax credit for the installation costs incurred in years prior to the year of change.

Rev. Rul. 76-437

Advice has been requested whether under the circumstances described be-

low, the investment tax credit is allowable for labor and material costs incurred prior to 1974 that are incident to the installation of depreciable assets.

The taxpayer is engaged in the business of leasing certain depreciable electronic equipment. The equipment has an estimated useful life of 5 years. Prior to 1974, the taxpayer deducted the cost of labor and materials incident to the installation of the leased equipment in the year in which installed.

The taxpayer desired to change its method of accounting with respect to installation costs, and filed a Form 3315, Application for Change in Accounting Method in accordance with Rev. Proc. 70-27, 1970-2 C.B. 509. The taxpayer was granted permission to change to the method of capitalization of installation costs and the recovery thereof through an allowance for depreciation as provided in section 167 of the Internal Revenue Code of 1954, beginning with the taxable year 1974. The resulting adjustment, made pursuant to section 481, consisted of the installation costs of equipment still in service as of January 1, 1974, less allowable depreciation on those costs to that date.

In connection with the January 1, 1974, capitalization of installation costs of assets placed in service during the years 1969 through 1973, the taxpayer filed claims for refund of income taxes on the ground that it was entitled to investment credit on the installation costs of assets placed in service in each of those years.

Section 1.446-1(e)(2)(ii)(b) of the Income Tax Regulations states, in part, that a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets that have been consistently treated as an expense in the year of purchase involves the question of proper timing of an item, and is treated as a change in method of accounting.

Section 481 of the Code prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. Section 481(a)(2) provides that the section 481(a) adjustment resulting from a change in accounting method will include only those amounts that are determined to be necessary solely by reason of the change, and there shall not be taken into account any adjustment in respect of any taxable year other than the year of change.

Section 1.481-1(a)(1) of the regulations states, in part, that in computing taxable income for the taxable year of the change, there is taken into account those adjustments that are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted. The year of change is the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year. Section 1.481-1(c)(1) states, in part, that in the case of a change in the treatment of a single material item, the amount of the adjustment is determined with reference only to the net dollar balances in that particular account.

Section 1.46-3(d)(4)(i) of the regulations states, in part, that the investment credit allowed by section 38 of the Code with respect to any property is allowed only for the first taxable year in which such property is placed in service by the taxpayer. The determination of whether property is section 38 property in the hands of the taxpayer is made with respect to that first taxable year.

Section 1.48-1 of the regulations defines section 38 property, in part, as property with respect to which depreciation is allowable to the taxpayer. Section 1.48-1(b)(1) states, in part, that property is not section 38 property unless a deduction for depreciation (or amortization in lieu of depreciation) with respect to such property is allowable to the taxpayer for the taxable year. A deduction for depreciation is allowable if the property is of a character subject to the allowance for depreciation under section 167 of the Code and the basis (or cost) of the property is recovered through a method of depreciation.

Section 1.48-1(b)(3) of the regulations further states that if the cost of the property is not recovered through a method of depreciation but through a deduction of the full cost in one taxable year, a deduction for depreciation with respect to such property is not allowable to the taxpayer. However, if an adjustment with respect to the income tax return for a taxable year in which property was placed in service requires the cost of such property to be recovered through a method of depreciation, rather than deducted currently, a deduction for depreciation will be considered allowable to the taxpayer as to the property that was placed in service in the taxable year of such adjustment for purposes of determining whether such property is section 38 property.

Under section 1.446-1(e)(2)(ii)(b) of the regulations, the taxpayer's change, beginning with the taxable year 1974, to require depreciation in lieu of a deduction for the cost of a class of depreciable assets, is a change to which section 481 applies.

Under section 1.481-1(c)(1) of the regulations, when the change in accounting method is to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which have been consistently treated as an expense in the year of purchase, the section 481 adjustment will necessarily include as a component the amount of depreciation that would have been allowed had the cost of the assets been recovered through a method of depreciation in the years prior to the year of the change. The

fact that an allowance for depreciation is taken into account in the computation of the section 481 adjustment is not determinative that depreciation is considered allowable for purposes of claiming the investment tax credit. *See* section 1.48-1(b)(3).

Under the regulations concerning the investment tax credit, the installation costs incurred in 1974 and in subsequent taxable years meet the depreciation allowable requirement of section 38 property. However, the application of section 481 of the Code, by reason of the limitation provided in section 481(a)(2), precludes adjustment to any taxable year prior to the year of the change.

Accordingly, the taxpayer is not allowed investment tax credits on installation costs incurred in years prior to 1974, the taxable year of change in method of accounting for such installation costs.

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26 CFR 1.48-1: Definition of section 38 property.

Whether the denial of the investment credit provided in section 48(a)(4) of the Code applies to a corporation that leases "section 38 property" to a nonexempt cooperative organization. See Rev. Rul. 76-260, page 5.

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26 CFR 1.48-1: Definition of section 38 property.

Whether a liquefied natural gas (LNG) facility is public utility property within the definition of section 1.46-3(g) of the regulations for investment credit purposes. See Rev. Rul. 76-268, page 7.

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26 CFR 1.48-1: Definition of section 38 property.

Whether a foreign corporation may elect to treat a domestic corporate lessee as having acquired new section 38 property for investment credit purposes. See Rev. Rul. 76-515, below.

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26 CFR 1.48-4: Election of lessor of new section 38 property to treat lessee as purchaser.
(Also Sections 864, 881; 1.48-1, 1.864-2, 1.881-2.)

Investment credit; pass-through to domestic lessee by foreign lessor.

A foreign corporate lessor, not engaged in a trade or business in the United States, may not elect to pass-through to a domestic corporate lessee an investment credit attributable to new property leased to the domestic corporation.

Rev. Rul. 76-515

Advice has been requested whether a foreign corporation, under the circumstances described below, may elect to treat a domestic corporate lessee as having acquired new section 38 property, pursuant to section 48(d) of the Internal Revenue Code of 1954.

In July 1975, *X*, a foreign corporation not engaged in a trade or business within the United States within the meaning of section 864 of the Code and subject to tax pursuant to section 881(a), leased certain new property to *Y*, a domestic corporation. During the term of the lease the property was physically located in the United States. Pursuant to the terms of the lease agreement, *X* filed an election under section 48(d) to enable *Y* to claim the investment tax credit.

Section 38 of the Code allows a a credit against Federal income taxes for qualified investments in "section 38 property."

Section 48(d) of the Code provides that a person who is a lessor of property may elect with respect to any new section 38 property to treat the lessee as having acquired such property.

Section 1.48-4(a)(1)(i) of the Income Tax regulations provides, in part, that for the purposes of the election under section 48(d) of the Code, the property must be section 38 property in the hands of the lessor; that is, it must be property with respect to which depreciation is allowable to the lessor.

Section 1.48-1(b)(1) of the regulations provides, in part, that property is not section 38 property unless a deduction for depreciation with respect to such property is allowable to the taxpayer for the taxable year.

Section 1.881-2(a)(3) of the regulations provides that in determining the tax of a foreign corporation that at no time during the taxable year is engaged in a trade or business in the United States, deductions shall not be allowed in determining the amount subject to tax.

In the instant case, the deduction for depreciation is not allowable to *X* because *X* is not engaged in a trade or business within the United States. Therefore, the property in question is not section 38 property in the hands of *X*, the lessor.

Accordingly, *X* may not elect to treat *Y* as having acquired new section 38 property.

Subchapter B.—Computation of Taxable Income
Part I.—Definition of Gross Income, Adjusted Gross Income, and Taxable Income, etc.

Section 61.—Gross Income Defined

26 CFR 1.61-1: Gross income.
(Also Sections 102, 162, 165, 170; 1.102-1, 1.162-2, 1.165-1, 1.170A-1.)

Member of Congress; trust fund for travel expenses.

Contributions to a trust established to provide funds for certain travel expenses incurred by a taxpayer as a Member of Congress and the taxpayer's staff in connection with the performance of official duties do not qualify as gifts under section 102(a) of the Code and are includible in the taxpayer's gross income in the year received by the trust. However, the amounts disbursed for travel expenses are deductible business expenses, unexpended funds returned to the contributors on termination of the trust are deductible as a business loss, and any portion of the contributions donated from the terminated trust to charitable organizations is deductible to the extent provided in section 170.

Rev. Rul. 76-276

Advice has been requested concerning the Federal income tax treatment of contributions to and distributions from a trust that has been established to pay certain travel expenses incurred by the taxpayer and the taxpayer's staff.

The taxpayer, a Member of Congress, computes taxable income under the cash receipts and disbursements method of accounting. The taxpayer regularly incurred substantial travel expenses that exceeded the congressional allowance for such expenses. A trust was established for the purpose of providing funds for certain travel expenses incurred by the taxpayer and the taxpayer's staff in connection with the performance of official congressional duties.

Amounts are distributed from the trust to pay for expenses that: (1) exceed the taxpayer's congressional allowance for travel expenses; (2) are related to the taxpayer's service as a Member of Congress; (3) are incurred by the taxpayer or taxpayer's staff for travel between Washington, D.C., and the taxpayer's congressional district, or for travel within the taxpayer's congressional district, or for other travel that, in the opinion of the trustees, will allow the taxpayer to serve better the needs of the taxpayer's constituents. Members of the taxpayer's staff travel only where and when directed to do so by the taxpayer.

The funds received by the trust consist of cash contributions from the taxpayer's constituents and are maintained in a bank checking account that bears no interest. Checks may be drawn on the account only by, or under the supervision of, the individuals who serve as the trustees. The trust is to terminate when the taxpayer ceases to serve as the Member of Congress from the district presently represented. Upon termination of the trust, any unexpended funds are to be returned to the contributors or, if such return is not practical, donated to nationally recognized charitable organizations.

Section 61(a) of the Internal Revenue Code of 1954 and the regulations thereunder provide, in part, that gross income means all income from whatever source derived, except as otherwise provided by law.

Section 102(a) of the Code provides, in part, that gross income does not include the value of property acquired by gift. A gift in this statutory sense proceeds from a "detached and disinterested generosity * * * out of affection, respect, admiration, charity or like impulses." *Commissioner v. Duberstein,* 363 U.S. 278, 285 (1960), 1960-2 C.B. 428, 431.

In the instant case the contributions enable the Member of Congress to become more accessible to constituents which, in turn, provides constituents with the opportunity of obtaining more effective representation in Congress.

Accordingly, under the principles set forth in *Duberstein,* the contributions do not qualify as gifts within the contemplation of section 102(a) of the Code.

In *Mount Vernon Gardens, Inc. v. Commissioner,* 298 F.2d 712 (6th Cir. 1962), *aff'g on this issue,* 34 T.C. 598 (1960), the taxpayer entered into a trust agreement with a bank pursuant to a contract with a third party. Under the agreement the taxpayer deposited in trust certain proceeds that would have been income to the taxpayer absent the trust agreement. The trust agreement provided that upon written instructions from the taxpayer the independent trustee was to expend the funds for certain limited purposes that would benefit the taxpayer. Relying on the fact that it was contractually obligated to transfer funds to the trust, the taxpayer argued that such funds were not includible in gross income. This argument was rejected by the court, which stated:

> But the creation of a trust into which a portion of the purchase price is paid is not in and of itself sufficient to prevent the trust money from being treated as income. * * * The questions of control by, and inurement to the benefit of, the taxpayer, are of prime importance.

Because the taxpayer was the prime beneficiary of the trust funds and effectively controlled their disposition, the court in *Mount Vernon Gardens, Inc.* held the funds includible in the taxpayer's gross income even though they had been deposited in a valid trust governed by an independent trustee.

In the instant case, the taxpayer can control the distribution of trust funds by determining the extent to which the taxpayer or members of the taxpayer's staff will travel in connection with the discharge of the taxpayer's congressional duties and responsibilities. The payment of the expenses incurred in such travel is a direct and substantial benefit to the taxpayer. Thus, the taxpayer's control over the payment of trust funds for purposes that benefit the taxpayer is as absolute as that in the *Mount Vernon Gardens, Inc.* case.

Accordingly, the amounts contributed to the trust are includible in the taxpayer's gross income for the year in which such amounts are received by the trust.

Section 162(a) of the Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses while away from home in the pursuit of a trade or business. Section 162(a) provides, in part, that the place of residence of a Member of Congress within the state or congressional district that is represented by the Member of Congress will be considered the home of the Member of Congress. Section 7701(a)(26) provides that the term "trade or business" includes the performance of the functions of a public office.

Accordingly, amounts disbursed from the trust to pay for travel expenses incurred by the taxpayer's staff and by the taxpayer while away from

home in pursuit of the taxpayer's trade or business of being a Member of Congress are deductible by the taxpayer as ordinary and necessary business expenses under section 162(a) of the Code.

Section 165(a) of the Code provides the general rule that there will be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c) provides, in part, that in the case of an individual, the deduction under section 165(a) will be limited to losses incurred in a trade or business.

In Rev. Rul. 67-48, 1967-1 C.B. 50, a cash basis taxpayer breached an employment contract and thereby became liable to pay to the former employer liquidated damages representing certain excess salary that had been paid to the taxpayer during an employment-related training period and had been reported as income for the years in which received. Rev. Rul. 67-48 holds that since the amount of liquidated damages paid by the taxpayer to the employer is attributable to compensation received for services rendered, such amount qualifies as a business loss under section 165(c)(1) of the Code. It specifies that the deduction is allowable in the year paid, but only if the taxpayer itemizes his deductions.

The instant case presents an analogous situation in the sense that amounts required to be included in gross income of the taxpayer may have to be returned to their source. In the event that the trust is terminated, any of these unexpended amounts are required, within the limits of practicality, to be returned to contributors.

Accordingly, if the taxpayer itemizes deductions, the taxpayer is entitled to a business loss deduction under section 165 of the Code for those unexpended amounts that are returned to the contributors. The deduction is allowable for the year of the repayment.

Further, any portion of the contributions that is donated to organizations described in section 170(c) of the Code is deductible by the taxpayer in the year of donation as a charitable contribution under section 170, subject to the limitations contained therein.

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26 CFR 1.61-1: Gross income.

Relocation payments; Housing and Community Development Act. Relocation payments received by individuals under section 105(a)(11) of Title I of the Housing and Community Development Act of 1974 are in the nature of general welfare and are not includible in gross income.

Rev. Rul. 76-373

Advice has been requested concerning the treatment for Federal income tax purposes of "relocation payments" received by individuals pursuant to the Housing and Community Development Act of 1974, section 105(a)(11), Pub. L. No. 93-383, 93rd Cong., 2d Sess. (August 22, 1974).

The stated objective of Title I (Community Development) of the Housing and Community Development Act of 1974 is the development of viable urban communities, by providing decent housing and a suitable living environment and expanding opportunities, principally for persons of low and moderate incomes. Section 105(a)(11) of the Act and the regulations thereunder provide, in part, that a community development program may provide for relocation payments and assistance for individuals displaced by activities assisted under Title I. These payments and assistance include all benefits at least equal to the minimum levels established under the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, section 202, 1971-1 C.B. 540.

Section 202 of the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970 provides, in pertinent part, for payment to any displaced person for actual reasonable expenses in moving such persons, such person's family or such person's personal property and payment for actual direct losses of tangible personal property as a result of moving.

Section 61(a) of the Internal Revenue Code of 1954 and the Income Tax Regulations thereunder provide that, except as otherwise provided by law, gross income means all income from whatever source derived.

The Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not includible in a recipient's gross income. See Rev. Rul. 74-205, 1974-1 C.B. 20, which holds that replacement housing payments received by individuals prior to January 2, 1971, pursuant to the Housing and Urban Development Act of 1968, 1968-2 C.B. 734, and the Uniform Relocation Assistance and Real Property Acquisitions Policies Act of 1970, are not includible in the gross incomes of the recipients.

Accordingly, relocation payments received by individuals pursuant to section 105(a)(11) of the Housing and Community Development Act of 1974 are in the nature of general welfare and, as such, are not includible in the gross incomes of the recipients.

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26 CFR 1.61-1: Gross income.

Home rehabilitation grants; community development program. Home rehabilitation grants received by low-income homeowners residing in a defined area of a city under the city's community development program funded under the Housing and Community Development Act of 1974 are in the nature of general welfare and are not includible in their gross income.

Rev. Rul. 76-395

Advice has been requested whether,

under the circumstances described below, home rehabilitation grants received by certain low-income homeowners are includible in their gross incomes under section 61 of the Internal Revenue Code of 1954.

Pursuant to the provisions of chapter 69, 42 U.S.C. sections 5301 through 5317 (Supp. 1975), added by the Housing and Community Development Act of 1974, a city applied for and received a grant for a community development program. The stated objective of chapter 69 is the development of viable urban communities, by providing decent housing and a suitable living environment and expanding economic opportunities, principally for persons of low and moderate income.

Under the city's community development program, home rehabilitation grants of up to $3,500 are made to certain homeowners who reside in a defined area of the city. To qualify for a grant, the individual must own and occupy a home and the annual income of the individual's household must not exceed $5,000. The recipient must agree to permit the city to inspect the home, screen and approve contractors, and inspect the contractors' work. The city provides assistance to protect the recipient from over-charges and poor workmanship. The grant funds must be utilized primarily for the correction of critical code violations, defined as those that endanger the health, safety, and welfare of the household, such as a defective furnace, defective plumbing, or illegal electrical wiring. Any remaining funds must be used first to correct noncritical code violations, such as scaling paint and floors requiring finishing, then to correct deficiencies that may soon become code violations, such as an old roof, and finally to make general property improvements.

Section 61(a) of the Code and the Income Tax Regulations thereunder provide that, except as otherwise provided by law, gross income means all income from whatever source derived.

The Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for promotion of general welfare are not includible in an individual's gross income. See, for example, Rev. Rul. 74-205, 1974-1 C.B. 20, concerning replacement housing payments received under the Housing and Urban Development Act of 1968 and the Uniform Relocation Assistance and Real Property Acquisitions Policies Act of 1970, and Rev. Rul. 75-271, 1975-2 C.B. 23, concerning mortgage assistance payments received under section 235 of the National Housing Act.

Accordingly, in the instant case, the home rehabilitation grants received by low-income homeowners are in the nature of general welfare and are not includible in their gross incomes.

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26 CFR 1.61-1: Gross income.
(Also Sections 851, 856, 895, 7701; 1.851-2, 1.856-2, 1.895-1, 301.7701-13.)

Government securities and obligations; SBA debenture guaranty agreements. Guaranty agreements issued by the Small Business Administration (SBA) evidencing ownership of Small Business Investment Company debentures sold to investors by the SBA and held by it as bailee are Government securities within the meaning of sections 851(b)(4) and 856(c)(5)(A) of the Code, and obligations of the U.S. within the meaning of sections 7701(a)(19)(C)(ii) and 895.

Rev. Rul. 76-426

Advice has been requested concerning the Federal income tax treatment of certain debentures that are guaranteed by the Small Business Administration (SBA), an agency of the United States, under the circumstances described below.

Some Small Business Investment Companies (SBICs) sell their debentures to the SBA. The SBA reoffers the debentures pursuant to guaranty agreements covering a specific debenture or debentures identified in a debenture register maintained by the SBA. Ownership of the debentures is evidenced by the guaranty agreements duly executed by the SBA, and issued to the investors.

The "Guaranty Agreement" provides that the SBA will hold the SBIC debentures as bailee for the benefit of the investor. Each debenture is payable to the SBA, which, as collection agent and bailee for the investor, has agreed in the Guaranty Agreements to remit such payments from the SBIC to the investor. The SBA unconditionally guarantees to the investor the timely payment of principal and interest, irrespective of the validity, regularity, or enforceability of the debentures or any other circumstances that might constitute a legal or equitable discharge or defense of a guarantor.

The Guaranty Agreement further provides, in part, as follows:

By the acceptance of this Agreement the Holder hereby agrees that if, in the opinion of SBA, any act has occurred or any condition exists which would, under the terms of any or all of the Debentures or any agreement with SBA or any other debt instrument held or guaranteed by SBA, enable SBA to accelerate the maturity thereof whether or not held by SBA, SBA shall, notwithstanding its status as bailee, have the right to take any and all action as SBA shall deem desirable respecting such Debenture or Debentures (including assignment to SBA as principal by SBA as bailee) and the Obligor or Obligors thereon without notice to the Holder, provided, however, that no such action shall alter in any way SBA's obligations to the Holder pursuant to its guaranty as set forth in Section 1 hereof. In the event of any such assignment, acceleration or other liquidation of the indebtedness represented by any Debenture or Debentures, the Debenture or Debentures so assigned, accelerated or otherwise liquidated shall continue to be identified on the debenture register as being covered by this Guaranty Agreement, payments to the Holder being made in accordance with the terms of such Debenture or Debentures pursuant to SBA's guaranty thereof. Whenever in this Guaranty-Agreement reference is made to a Debenture or Debentures, such reference shall be deemed to apply to the Debenture or Debentures listed in the debenture register as being covered by this Guaranty Agreement, irrespective of whether such Debenture or Debentures

shall be then outstanding and/or held by SBA.

In addition, the Guaranty Agreement states, in part, that the guaranty of the SBA and its undertakings as collection agent are backed by the revolving fund established under section 4(c)(1)(B) of the Small Business Act, as amended is U.S.C.A. section 633 (supp. 1976), and by the full faith and credit of the United States.

Accordingly, the holder of a Guaranty Agreement will be treated for Federal income tax purposes as the owner of:

(1) "Government securities" within the meaning of sections 851(b)(4) and 856(c)(5)(A) of the Internal Revenue Code of 1954.

(2) "Obligations of the United States" within the meaning of section 7701(a)(19)(C)(ii).

(3) "Obligations of the United States or of any agency or instrumentality thereof" within the meaning of section 895.

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26 CFR 1.61-1: Gross income.

Whether the Service will issue advance rulings that certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes when the property is "limited use property." See Rev. Proc. 76-30, page 647.

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26 CFR 1.61-1: Gross income.

Tuition payments paid by an employer on behalf of an employee. See Rev. Rul. 76-352, page 37.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.
(Also Sections 170, 3121, 3401; 1.170A-1, 31.3121(b)(8)-1, 31.3401(a)(9)-1.)

Gross income; members of religious order employed outside religious community. Amounts received by members of an exempt religious order, not acting as agents of the order, for work performed outside the religious community and paid over, in full or part, to the order at its direction, are includible in the gross incomes of the members and are wages subject to the FICA and income tax withholding. However, the individual members are entitled to charitable contribution deductions under section 170 of the Code for amounts donated to the order.

Rev. Rul. 76-323

Advice has been requested whether, under the circumstances described below, amounts received by two members of a religious order during the time they secured employment outside the order are includible in their gross incomes and subject to the taxes imposed by the Federal Insurance Contributions Act and the Collection of Income Tax at Source on Wages (chapters 21 and 24, respectively, subtitle C, Internal Revenue Code of 1954). Advice has also been requested whether any amounts includible in gross income that are turned over by the members to the order are deductible from gross income under section 170 of the Code.

Pursuant to the regulations of the order, all members must secure employment outside the order and turn over all their remuneration for such employment to the order, less the money, if any, retained for their living expenses. Pursuant to such regulations, member *A* sought and secured employment with a plumbing company, and member *B* sought and secured employment with a construction company on a construction project in a distant state. Because of the distance of member *B*'s employment from the residence maintained by the order, member *B* secured living quarters near the job; member *A* was able to continue living in the residence. Each member retained full status as a member of the order with all privileges and duties associated therewith. The members were still under the authority of the superiors of the order and had to account to them for all the remuneration earned and living expenses incurred.

The religious order is an organization described in section 170(c)(2) of the Code, contributions to which are deductible.

Section 61 of the Internal Revenue Code of 1954 provides that gross income means all income from whatever source derived, including compensation for services. In addition, section 1.61-2(c) of the Income Tax Regulations provides, in pertinent part, that where, pursuant to an agreement or understanding, services are rendered to a person for the benefit of an organization described in section 170(c) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services.

Moreover, as a general rule, an assignment or similar transfer by a taxpayer of compensation for personal services to another individual or entity is an ineffectual method of relieving a taxpayer of Federal income tax liability on the transfer regardless of the motivation behind the transfer. See *Lucas v. Earl,* 281 U.S. 111 (1930); *Helvering v. Horst,* 311 U.S. 112 (1940), 1940-2 C.B. 206; *Helvering v. Eubank,* 311 U.S. 122 (1940), 1940-2 C.B. 209.

Section 170 of the Code provides, subject to certain limitations, a deduction for gifts and contributions to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

Section 3121(b)(8)(A) of the Federal Insurance Contributions Act excepts from the term "employment" service performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of the ministry or by a member of a religious order in the exercise of duties required by such order.

Section 3401(a)(9) of the Code, relating to income tax withholding, excepts from "wages" remuneration paid for services performed by a duly ordained, commissioned, or licensed

minister of a church in the exercise of the ministry or by a member of a religious order in the exercise of duties required by such order.

Sections 31.3121(b)(8)-1(d) and 31.3401(a)(9)-1(d) of the Employment Tax Regulations provide that service performed by a member of a religious order in the exercise of duties required by such order includes all duties required of the member of the order. The nature or extent of such service is immaterial so long as it is a service that the member is directed or required to perform by ecclesiastical superiors.

Income Tax Aspects: In the instant case, the members were performing services for others in order to earn money to benefit the religious order by paying the remuneration over to it. The members were not acting as agents of the order, but were receiving compensation on their own behalf and transferring it to the order.

Accordingly, each member is required to include in gross income the entire remuneration received, whether or not retained for living expenses, as long as such remuneration is not excludable under any provision of the Code. However, since the religious order is an organization described in section 170(c)(2) of the Code, contributions to which are deductible, each member is entitled to a charitable contribution deduction in the manner and to the extent provided by section 170 of the Code for the amounts donated to the religious order.

Employment Tax Aspects: In order for the employment of a member of a religious order to constitute the exercise of duties required by such order within the meaning of the Employment Tax Regulations, the services must be of the type that are ordinarily the duties of members of the order and must be performed by the member as part of the duties for or on behalf of the religious order as its agent. In determining whether particular services are of the type that are ordinarily the duties of members of the order, consideration will be given to the established activities of the organization. Ordinarily, a member is performing services as the agent of the religious order only if the order is engaged in the performance of the services as a principal. Ordinarily an order is not engaged in the performance of services as a principal where the legal relationship of employer and employee exists between the member and the third party with respect to the performance of such services.

In the instant case, the services performed were not of the type ordinarily required by members of a religious order. In addition, the members were employees and agents of the plumbing company and construction company, respectively, and were not acting for or on behalf of the religious order in performing their services. Accordingly, although the members were required by the order to obtain outside employment, and to turn over to the order the wages earned, the services performed by the members as employees of the plumbing company and the construction company are not considered the exercise of duties required by such order.

Accordingly, the entire remuneration received by member *A* and member *B* is subject to the taxes imposed by the Federal Insurance Contributions Act and the Collection of Income Tax at Source on Wages. The employers are liable for the payment of any such taxes due.

Compare Rev. Rul. 68-123, 1968-1 C.B. 35, which holds that amounts received from a hospital by a registered nurse who is a member of a religious society exempt from Federal income tax under section 501(c)(3) of the Code are excludable from gross income under section 61(a) and are not wages subject to Federal income tax withholding.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.
(Also Section 165; 1.165-1.)

Advance payment toward informant's award. A payment received by a cash basis taxpayer from the U.S. Government as an advance on an informant's award of an undetermined amount is includible in gross income in the year received. The subsequent repayment of a portion of the advance in excess of the award is deductible in the year repaid as an itemized deduction under section 165(a) of the Code.

Rev. Rul. 76-374

Advice has been requested concerning the treatment for Federal income tax purposes of a payment received by a taxpayer as an advance toward an award for information furnished by the taxpayer under the circumstances described below.

The taxpayer, who uses the cash receipts and disbursements method of accounting, received an advance payment toward an award during the taxable year from the United States Government for supplying information relating to violations of certain United States laws. At the time the advance payment was made no firm amount was established for the award. The amount of the award will be established in a subsequent year. In the event the award is established in an amount in excess of the advance, the taxpayer will receive such excess amount. If the award is established in an amount less than the advance, the taxpayer will be required to refund such difference to the United States Government.

Section 61 of the Internal Revenue Code of 1954 defines gross income as all income, from whatever source derived, except as otherwise provided by law.

Section 1.61-2 of the Income Tax Regulations includes in gross income compensation for services such as fees,

commissions, and similar items including rewards.

Section 165(a) of the Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(c) of the Code provides that in the case of an individual, the deduction under subsection 165(a) shall be limited to certain types of losses, including losses incurred in any transaction entered into for profit, though not connected with a trade or business.

In *North American Oil Consolidated v. Burnet,* 286 U.S. 417 (1932), XI-1 C.B. 293, the Supreme Court of the United States stated that if a taxpayer received earnings under a claim of right and without restriction as to its disposition, the taxpayer has received income that the taxpayer is required to report, even though it may still be claimed that the taxpayer is not entitled to retain the money, and even though the taxpayer may still be adjudged liable to restore its equivalent.

Accordingly, in the instant case, the payment received by the taxpayer as an advance toward an award to be made for information furnished by the taxpayer is includible in the taxpayer's gross income in the year received.

Further, in the event the taxpayer is required to repay any part of the advance to the United States Government in a subsequent year, the amount of such repayment is deductible in the year repaid pursuant to section 165(a) of the Code provided the taxpayer itemizes deductions.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

Physician fees required to be assigned to hospital foundation. Physician-members of a nonprofit research and educational foundation formed by a hospital's medical staff, all of whom are required to be members of the foundation, are not required to include in their gross incomes fees from certain patients, known as teaching cases, that they are required to assign to the foundation.

Rev. Rul. 76-479

Advice has been requested whether, under the circumstances described below, fees paid to a nonprofit research and educational organization for professional services rendered by its physician-members are includible in the gross incomes of such physician-members under section 61 of the Internal Revenue Code of 1954.

The medical staff of a nonprofit hospital formed a nonprofit research and educational foundation to study and discuss and to experiment by means of laboratory and clinical procedures with respect to, the cause, nature, prevention, and cure of diseases. All the members of the hospital's medical staff are required to be members of the research and education foundation. To implement its goals the foundation agreed to provide medical service to patients with limited incomes. These patients, known as teaching cases, are referred from the hospital's out-patient clinic or emergency room, and have no regular attending physician. In addition, all patients whose hospital care is paid for by the county in which the hospital is located are considered teaching cases. Fees for the medical services rendered are based on a patient's ability to pay.

Each member of the medical staff executes an assignment form that enables the foundation to collect all fees generated from providing medical treatment to the teaching cases. Most of the members of the hospital's medical staff are physicians engaged in private practice, although some of the members of the medical staff are physicians employed by the hospital on a full or part-time basis.

Section 61(a) of the Code provides that, unless otherwise excluded by law, gross income means all income from whatever source derived including, but not limited to, compensation for services, including fees and similar items. Additionally, section 1.61-2(c) of the Income Tax Regulations provides, in part, that where, pursuant to an agreement or understanding, services are rendered to a person for the benefit of an organization described in section 170(c) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid is income to the person performing the services.

Moreover, as a general rule, an assignment or similar transfer by a taxpayer of compensation for personal services to another individual or entity is an ineffectual method of relieving a taxpayer of Federal income tax liability on the transfer regardless of the motivation behind the transfer. See *Lucas v. Earl,* 281 U.S. 111 (1930); *Helvering v. Horst,* 311 U.S. 112 (1940), 1940-2 C.B. 206; *Helvering v. Eubank,* 311 U.S. 122 (1940), 1940-2 C.B. 209.

However, the Internal Revenue Service has recognized that amounts received by an agent on behalf of a principal, and turned over to the principal, are not taxable to the agent under section 61(a) of the Code. See for example, Rev. Rul. 74-581, 1974-2 C.B. 25, which holds that fees paid by a Federal District Court to a university's attorney-faculty members and students for representing indigent clients, while participating in the university's clinical program that is part of its regular curriculum, are not includible in the gross income of the students or attorney-faculty members, when pursuant to an agreement between the university and the participating attorney-faculty members and students such fees are turned over to the university. See also Rev. Rul. 69-274, 1969-1 C.B. 36, Rev. Rul. 65-282, 1965-2 C.B. 21, Rev. Rul. 58-515, 1958-2 C.B. 28, and Rev. Rul. 58-220, 1958-1 C.B. 26, that discuss other

agency situations where amounts received are not includible under section 61(a).

In the instant case, membership in the research and educational foundation is a condition precedent to being a member of the hospital's medical staff, and such membership requires that any fees for treating teaching cases must be paid to the research and education foundation. The members of the hospital's medical staff, as individuals, have no control over the fees charged, or the collection and disbursement of such fees. It is the foundation that has established the program to provide medical services to patients with limited incomes and the foundation that obtains research information as a result of providing such services. Thus, the members of the medical staff of the hospital are acting as agents of the foundation when performing such services under the circumstances described.

Accordingly, in the instant case, any fees derived from treating teaching cases are not includible in the gross incomes of the physicians rendering such services.

Compare Rev. Rul. 76-323, page 18, this Bulletin, which holds that amounts received by members of a religious order for work performed outside the religious community, whether or not retained for living expenses, are includible in the gross incomes of such members, since in performing these services the members are not acting as agents of the religious order.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

Treatment of amounts received by resident doctors in a Family Practice Residency Program. See Rev. Rul. 76-252, page 36.

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26 CFR 1.61-2: Compensation for services, including fees, commissions and similar items.

Whether a salary received by a faculty member on a special leave of absence is includible in gross income. See Rev. Rul. 76-286, page 41.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

Whether amounts earned by members of a religious organization performing services under contracts between it and several forest owners are includible in their gross incomes. See Rev. Rul. 76-341, page 307.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

Whether monthly payments to volunteer firefighters based on length of service and their surviving spouses are excludable from gross income as gifts. See Rev. Rul. 76-516, page 24.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

The treatment of amounts received by a member of the Uniformed Services participating in a scholarship program. See Rev. Rul. 76-518, page 39.

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26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

The treatment of amounts received by a member of the Uniformed Services participating in a scholarship program. See Rev. Rul. 76-519, page 39.

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26 CFR 1.61-6: Gains derived from dealings in property.
(Also Section 1001; 1.1001-1.)

Realization of gain; real property exchanged for silver coins. A taxpayer, not a dealer in coins or currency, who receives U.S. silver coins having a value in excess of their face value in exchange for appreciated real property realizes a taxable gain based on the excess of the fair market value of the coins over the adjusted basis of the real property.

Rev. Rul. 76-249

Advice has been requested whether the currency value of coins or their fair market value should be used in determining the Federal income tax result of the transaction described below.

A taxpayer, who is not a dealer in coins or currency, exchanged real property with an adjusted basis of $2,000 and a fair market value of $6,000 for United States silver coins having a face value of $2,000 and a fair market value of $6,000.

Section 61 of the Internal Revenue Code of 1954 provides, in part, that gross income means all income from whatever source derived including, but not limited to, gains derived from dealing in property.

Section 1001(a) of the Code provides, in part, that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis of the property. Section 1001(b) provides, in part, that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Under the circumstances described above, the silver coins received by the taxpayer for the real property were themselves property. Accordingly, the taxpayer exchanged real property with an adjusted basis of $2,000 for property (silver coins) with a fair market value of $6,000, and under the provisions of section 1001 of the Code realized a taxable gain of $4,000.

See Rev. Rul. 68-634, 1968-2 C.B. 46, which holds that a premium received by a taxpayer, not a dealer in coins or currency, on the sale of silver certificates is a gain on the disposition of property.

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26 CFR 1.61-7: Interest.

Whether interest on obligations to be issued by a political subdivision of a state will be exempt from tax. See Rev. Rul. 76-480, page 25.

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26 CFR 1.61-9: Dividends.

Whether dividends received by a parent corporation from its wholly owned life insurance company subsidiary should be

treated as personal holding company income under the circumstances described. See Rev. Rul. 76-320, page 181.

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26 CFR 1.61-12: Income from discharge of indebtedness.

Unpaid interest forgiven; subsidiary indebtedness to corporate shareholder; accrual method. The forgiveness by a corporation of interest indebtedness of its solvent, accrual method, wholly owned subsidiary that had deducted such interest in prior taxable years and derived a tax benefit therefrom resulted in the receipt of income by the subsidiary in the year of forgiveness; Rev. Rul. 73-432 superseded.

Rev. Rul. 76-316

The Internal Revenue Service has reconsidered Rev. Rul. 73-432, 1973-2 C.B. 17, concerning the application of section 61 of the Internal Revenue Code of 1954 where a solvent corporation using an accrual method of accounting received forgiveness of a debt. The debt, representing principal and interest, was owed by the corporation to its sole shareholder. The shareholder forgave 8*x* dollars of accrued interest owed on the principal debt. The corporation had received a tax benefit from the interest deduction on its Federal income tax return.

Rev. Rul. 73-432 holds that the corporation realized gross income when its sole shareholder forgave interest indebtedness that when previously deducted resulted in a tax benefit to it. That Revenue Ruling also makes a reference to the announcement regarding the substitution of acquiescence in result only for acquiescence in the case of *Utilities & Industries Corporation,* 41 T.C. 888 (1964), *acq.,* 1965-1 C.B. 3, 1973-2 C.B. 4.

Upon reconsideration it has been determined that the factual pattern presented in Rev. Rul. 73-432, failed to illustrate the intended point. Therefore, the following situation is presented to illustrate the application of section 61 of the Code with respect to a foregiveness of debt that Rev. Rul. 73-432 was intended to illustrate.

P, a domestic corporation reporting its income under an accrual method of accounting, was the sole shareholder of *S*, a domestic subsidiary corporation, which was in debt to it for the principal amount of 40*x* dollars and for accrued interest in the amount of 8*x* dollars. *S* reported its income under an accrual method of accounting and had deducted the interest on its Federal income tax returns for prior years and had received a tax benefit therefrom. *P* forgave the 8*x* dollars interest owed it by *S* at a time when *S* was neither bankrupt nor insolvent.

The specific question is whether the forgiveness of interest in the above situation is income to *S* to the extent of its prior tax benefits.

Section 61(a)(12) of the Code states that gross income includes income from the discharge of indebtedness. An exception to this general rule is contained in section 1.61-12(a) of the Income Tax Regulations, which provides, in part, as follows:

> In general—The discharge of indebtedness, in whole or in part, may result in the realization of income. * * *. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation *to the extent of the principal of the debt.* (Emphasis added.)

The intention of the emphasized language of section 1.61-12(a) of the regulations cited above is to make it clear that only the principal portion of the forgiven indebtedness will be considered a contribution to capital. The interest portion should be included in the debtor's gross income in the year of forgiveness to the extent of any tax benefit the debtor derived from its deduction. *See* Rev. Rul. 68-104, 1968-1 C.B. 361, which holds that when amounts previously deducted from gross income (that thereby effected a tax benefit) are recovered in subsequent years, such recoveries are included in gross income for the year of recovery.

Accordingly, *S* realized gross income when its sole shareholder forgave the interest indebtedness that when previously deducted by *S* resulted in a tax benefit.

See reference above to the announcement regarding the substitution of acquiescence in the result only for acquiescence in the case of *Utilities & Industries Corporation.*

See Rev. Rul. 67-200, 1967-1 C.B. 15, as clarified by Rev. Rul 70-406, 1970-2 C.B. 16, with respect to the application of sections 108, 111, and 1017 of the Code under which interest forgiven may be excluded from gross income where there is a consent to the adjustment of the basis of the taxpayer's property.

Rev. Rul. 73-432 is clarified. Rev. Rul. 73-432, as clarified, is superseded since the factual pattern presented in this Revenue Ruling illustrates the point that Rev. Rul. 73-432 was intended to illustrate, and the substantive position of Rev. Rul. 73-432 is restated herein.

Section 62.—Adjusted Gross Income Defined

26 CFR 1.62-1: Adjusted gross income.

Treatment of daily transportation expenses incurred between an individual's residence and place of work. See Rev. Rul. 76-453, page 86.

Part II.—Items Specifically Included in Gross Income

Section 82.—Reimbursement for Expenses of Moving

26 CFR 1.82-1: Payments for or reimbursements of expenses of moving from one residence to another residence attributable to employment or self-employment.
(Also Sections 1034, 3121, 3122, 3401; 1.1034-1, 31.3121(a)-1, 31.3401(a)-1.)

Loss on sale of personal residence reimbursed by Government. Reimbursements received by Fed-

eral civilian employees or members of the Armed Forces from the Government for losses sustained on the private sale of personal residences, or the excess of the selling price received over the fair market value at the time of the sale resulting from Government purchases of the residences, as the result of the closing of a military base are includible in gross income as compensation for services under section 82 of the Code and, as such, are not considered a part of the selling price of the personal residences for purposes of the nonrecognition provisions of section 1034. Such reimbursements are "wages" for purposes of the FICA and income tax withholding, unless specifically excepted.

Rev. Rul. 76-342

Advice has been requested as to the Federal income tax treatment of payments received by Federal civilian employees or members of the Armed Forces under the provisions of 42 U.S.C. section 3374 (1970), as amended, (Supp. II, 1972; Supp. IV, 1975).

Section 3374(a) of Title 42 provides that the Secretary of Defense is authorized to acquire title to, hold, manage, and dispose of, or, in lieu thereof, to reimburse for certain losses upon private sale of, or foreclosure against, any property improved with a one- or two-family dwelling that is situated at or near a military base or installation that the Department of Defense has, subsequent to November 1, 1964, ordered to be closed in whole or in part, if (1) the owner of such property is, or has been a Federal employee at or in connection with such base or installation or a member of the Armed Forces assigned thereto, (2) the closing of such base or installation, in whole or in part, has required or will require the termination of such owner's employment or service at or in connection with such base or installation, and (3) as a result of the actual or pending closing of such base or installation, in whole or in part, or if as the result of such action and other similar action in the same area, there is no present market for the sale of such property upon reasonable terms and conditions.

Section 3374(k) of Title 42 provides that the benefits of section 3374 shall apply, as to closure actions in the several states and the District of Columbia announced after April 1, 1973, to otherwise eligible employees or personnel who are (1) employed or assigned either at or near the base or installation affected by the closure action, and (2) are required to relocate, due to transfer, reassignment or involuntary termination of employment, for reasons other than the closure action.

Section 3374(c) of Title 42 provides, in part, that eligible persons may elect either (1) to receive a cash payment as compensation for losses that may be or have been sustained in a private sale, in an amount not to exceed the difference between (A) 95 percent of the fair market value of their property prior to public announcement of intention to close all or part of the military base or installation and (B) the fair market value of such property at the time of the sale, or (2) to receive, as the purchase price for their property, an amount not to exceed 90 percent of the prior fair market value as such value is determined by the Secretary of Defense, or the amount of the outstanding mortgages.

Section 82 of the Internal Revenue Code of 1954 provides that with respect to taxable years beginning after December 31, 1969, there shall be included in gross income (as compensation for services) any amount received or accrued, directly or indirectly, by an individual as a payment for or reimbursement of expenses of moving from one residence to another residence that is attributable to employment or self-employment.

Section 1.82-1(a)(5) of the Income Tax Regulations provides that any amount received or accrued from an employer, a client, a customer, or similar person in connection with the performance of services for such employer, client, customer, or similar person, is attributable to employment or self-employment. Thus, for example, if an employer reimburses an employee for a loss incurred on the sale of the employee's house, reimbursement is attributable to the performance of services if made because of the employer-employee relationship. Similarly, if an employer in order to prevent an employee's sustaining a loss on a sale of a house acquires the property from the employee at a price in excess of fair market value, the employee is considered to have received a payment attributable to employment to the extent that such payment exceeds the fair market value of the property.

Section 1034(a) of the Code, as amended by the Tax Reduction Act of 1975, section 207, 1975-1 C.B. 545, 549, provides, in part, that if property used by the taxpayer as a principal residence is sold by the taxpayer and, within a period beginning 18 months before the date of such sale and ending 18 months after such date, property is purchased and used by the taxpayer as a principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence.

The cash payment that Federal civilian employees and members of the Armed Forces may elect to receive under the provisions of section 3374 (c) of Title 42 as compensation for losses that may be or have been sustained in a private sale of their personal residence is a payment attributable to their employment since it is received in connection with the performance of services for their employer. Accordingly, the amount received is includible in the gross income of the employee as compensation for services

under the provisions of section 82 of the Code. The payment is not considered a part of the selling price of the personal residence and, therefore, the nonrecognition provisions of section 1034 do not apply to such payment.

If the Federal civilian employees and members of the Armed Forces elect under section 3374(c) of Title 42 to receive as a purchase price from the Federal government 90 percent of the prior fair market value of their personal residences, or the amount of the outstanding mortgages, the amount by which such purchase price exceeds the fair market value of the personal residence at the date of sale is a payment attributable to their employment. Accordingly, the excess of the purchase price received over the fair market value of the personal residence at the time of sale is includible in the gross income of the employee as compensation for services under the provisions of section 82 of the Code. Since the excess is compensation, it is not part of the selling price of the personal residence and the nonrecognition provisions of section 1034 do not apply to such excess.

The amounts received by the Federal civilian employees and members of the Armed Forces under section 3374(c) of Title 42 that must be included in gross income as compensation for services under the provisions of section 82 of the Code are "wages" for purposes of the Federal Insurance Contributions Act and the Collection of Income Tax at Source on Wages (chapters 21 and 24, respectively, subtitle C, of the Code), unless specifically excepted. See sections 3121(a)(11), (i)(2), (m), (n) and 3122 with respect to the taxes imposed under the Federal Insurance Contributions Act and section 3401(a)(15) for purposes of Collection of Income Tax at Source on Wages.

Part III.—Items Specifically Excluded From Gross Income

Section 102.—Gifts and Inheritances

26 CFR 1.102-1: Gifts and inheritances. (Also Section 61; 1.61-2.)

Awards to retired volunteer firefighters. Monthly payments awarded by a county legislature to retired volunteer firefighters based on length of active service to county volunteer fire companies or to their surviving spouses are not excludable from the recipient's gross incomes as gifts.

Rev. Rul. 76-516

Advice has been requested whether, under the circumstances described below, amounts paid to retired volunteer firefighters or to their surviving spouses are excludable from gross income as gifts under section 102 of the Internal Revenue Code of 1954.

A county legislature enacted a bill providing only for awards to volunteer firefighters based on length of active service. Under this bill, a person who has reached the age of 60 and completed 25 years of certified active volunteer service with any county volunteer fire company is entitled to receive a monthly payment for life. If a volunteer firefighter dies while receiving benefits, the surviving spouse is entitled to receive for life 50 percent of the monthly payment the volunteer received while living.

Section 61(a) of the Code and the Income Tax Regulations thereunder provide that, except as otherwise provided by law, gross income means all income from whatever source derived.

Section 102(a) of the Code provides that gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

In *Commissioner* v. *Duberstein,* 363 U.S. 278 (1960), 1960-2 C.B. 428, the Supreme Court of the United States held that a gift, in the statutory sense, proceeds from a detached and disinterested generosity out of affection, respect, admiration, charity, or like impulses, and while the donor's intention is the most critical consideration, the donor's characterization of the donor's actions is not necessarily determinative. The absence of a legal or moral obligation to make a payment does not establish that it is a gift. If a payment proceeds from the constraining force of any moral or legal duty, or from the incentive of an anticipated benefit, it is not a gift. Furthermore, where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it.

In the instant case, the amounts paid to the volunteer firefighter based on length of active service do not proceed from a detached and disinterested generosity. Rather, such payments are intended to compensate the parties for past services performed for the community.

Accordingly, the monthly payments to the volunteer firefighters and their surviving spouses are not excludable from income as gifts under section 102 of the Code, but are includible in gross income under section 61.

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26 CFR 1.102-1: Gifts and inheritances.

Whether contributions by constituents of a Member of Congress to a trust for the purpose of paying certain of the travel expenses of the Member are gifts. See Rev. Rul. 76-276, page 14.

Section 103.—Interest on Certain Governmental Obligations

Arbitrage bonds; invested reserve fund; limitation. The amount by which an invested reserve fund exceeds 15 percent of the proceeds of bonds issued by a political subdivision of a state as a result of an accumulation of investment earnings, which was not a vital factor in marketing the bonds, may be invested in securities or obligations without causing the bonds to be arbitrage bonds under section 103(d) of the

Code only if the yield produced by such investment does not exceed the yield on the bonds issued.

Rev. Rul. 76-462

Advice has been requested whether, under the circumstances described below, an excessive amount in a reserve fund to be established with respect to certain bonds to be issued by a political subdivision of a state qualifies as being "necessary" under section 103(d)(4) of the Internal Revenue Code of 1954.

M, a political subdivision of a state, proposes to issue bonds to finance facilities for a private educational institution. Title to the facilities for which *M* issues the bonds will remain with *M*. *M* and the institution will execute a lease under which the institution will pay rent sufficient to meet the debt service on the bonds financing the facilities.

M proposes to establish a reserve fund for the bond issue that will be funded out of the proceeds of the bond issue in order to provide security for the bonds. The amount in the reserve fund will be invested. A portion of the investment earnings will be credited against the rent payable by the educational institution and the remaining portion will be retained in the reserve fund and invested.

The initial amount deposited in the reserve fund will be less than 15 percent of the proceeds of the issue of obligations issued by *M*. However, due to the accumulation of the investment earnings in the fund, it is reasonable to expect that at some point during the term of the issue, the amount in the reserve fund will exceed 15 percent of the proceeds of the issue. However, the total amount of investment earnings over the term of the issue from the investment of the reserve fund (including the investment of a portion of the earnings themselves) will not exceed the amount of investment earnings that could be reasonably expected to be earned over the term of the issue if the reserve fund were established at the time of issuance of the bonds and maintained throughout the term of the issue at an amount equal to 15 percent of the proceeds of the issue.

The prospective lessee relies on contributions for a significant part of its revenue, which adversely affects its credit standing. Therefore, in order to market the bonds issued by *M* and to provide these bonds with a favorable rating, *M* finds it necessary to establish the reserve fund. While the initial deposit to and maintenance of the reserve fund is a vital factor in marketing bonds of *M*, the accumulation of earnings in the fund is not a vital factor in marketing the bonds.

Section 103(d) of the Code provides that except as otherwise provided in section 103(d) any arbitrage bond shall not be treated as the obligation of a political subdivision, the interest on which is excludable from the gross income of the recipients thereof.

Section 103(d)(2) of the Code provides, in part, that the term "arbitrage bond" includes any obligation that is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly to acquire securities or obligations that may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue that is materially higher than the yield on obligations of such issue.

Section 103(d)(4) of the Code provides that an obligation shall not be treated as an arbitrage bond solely by reason of the fact that an amount of the proceeds of the issue of which such obligation is a part may be invested in securities or other obligations which are part of a reasonably required reserve or replacement fund. Section 103(d)(4) further provides that such amount shall not exceed 15 percent of the proceeds of the issue of which such obligation is a part unless the issuer establishes that a higher amount is necessary.

Accordingly, in the instant case, since the accumulation of earnings in the reserve fund is not a vital factor in marketing the bonds of *M*, if the aggregate of the original amount placed in the reserve fund plus the accumulation of investment earnings in the fund at any time exceeds the limitation of 15 percent of the proceeds of the issue provided in section 103(d)(4) of the Code, such excess amount will not be considered "necessary" within the meaning of section 103(d)(4). Therefore, any amounts held in such excessive reserve fund up to the limited amount set forth in section 103(d)(4) may be invested in materially higher yielding securities or obligations without causing the bonds issued by *M* to be arbitrage bonds under section 103(d). The amount held in the reserve fund in excess of the limitation of 15 percent of the proceeds of the issue provided in section 103(d)(4) may be invested in securities or obligations without causing the bonds to be arbitrage bonds under section 103(d) but only if the yield produced by such securities or obligations does not exceed the yield produced by the bonds to be issued by *M*.

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26 CFR 1.103-1: Interest upon obligations of a State, Territory, etc.
(Also Section 61; 1.61-7.)

Industrial development bonds; grain handling facilities. Interest on industrial development bonds issued by a political subdivision of a state to finance the acquisition, construction, and installation of grain handling facilities for use by a nonexempt corporation in conjunction with its grain elevator situated adjacent to a dock within a public port is excludable from the gross income of the bondholders.

Rev. Rul. 76-480

Advice has been requested whether, under the circumstances described below, the interest on bonds to be issued by a political subdivision of a state will be excludable from the gross incomes of the bondholders under the

provisions of section 103(a)(1) of the Internal Revenue Code of 1954.

The political subdivision proposes to issue industrial development bonds to finance the acquisition, construction and installation of facilities to be used by a corporation that is not an exempt person within the meaning of section 103(c)(3) of the Code. The bonds will not be "arbitrage bonds" as such term is defined in section 103(d).

The corporation's activities include the merchandising and storage of grain. In connection with such activities, the corporation owns and operates a terminal grain elevator in which it stores its own grain until sold to domestic or foreign users. In addition, the elevator is licensed as a public warehouse and the corporation stores grain for other parties. The elevator is situated next to a dock within a public port. Ships dock adjacent to the elevator for the purpose of loading and unloading grain.

In order to comply with air pollution control standards of the state in which the elevator is located, the corporation will acquire, construct, and install new grain handling facilities to replace the existing facilities used in loading and unloading the elevator. The new facilities will be essential to the continued operation of the grain elevator and will serve the same function as the old facilities. The new facilities will also have an air pollution control capability.

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state, territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.

Section 103(c)(1) of the Code provides that, except as otherwise provided in section 103(c), any industrial development bond shall be treated as an obligation that is not an obligation described in section 103(a)(1).

However, section 103(c)(4)(D) of the Code provides, in part, that section 103(c)(1) shall not apply to any obligation that is issued as part of an issue substantially all the proceeds of which are to be used to provide docks, wharves, or storage facilities directly related to docks or wharves.

Section 1.103-8(e)(1) of the Income Tax Regulations provides, in part, that section 103(c)(1) of the Code shall not apply to obligations issued by a state or local governmental unit that are part of an issue substantially all of the proceeds of which are to be used to provide docks, wharves, or storage facilities directly related to docks or wharves. In order to qualify as an exempt facility, the facility must satisfy the public use requirement of section 1.103-8(a)(2) by being available for use by members of the general public or for use by common carriers or charter carriers that serve members of the general public. A dock or wharf that is part of a public port satisfies the public use test.

Section 1.103-8(e)(2)(ii) of the regulations defines a dock or wharf to include property that is functionally related and subordinate to a dock or wharf such as the structure alongside which a vessel docks, the equipment needed to receive and to discharge cargo and passengers from the vessel, such as cranes and conveyors, related storage, handling, office and passenger areas, and similar facilities.

Section 1.103-8(e)(3) of the regulations provides, in part, that section 103(c)(4)(D) of the Code includes only those storage facilities that are directly related to a dock or wharf and are physically located on or adjacent to such facility. A storage facility would include a grain elevator, silo, warehouse, or oil and gas storage tank used in connection with a dock or wharf and located on or adjacent to such dock or wharf.

Section 103(c)(4)(F) of the Code provides, in part, that section 103(c)(1) shall not apply to any obligation that is issued as part of an issue substantially all the proceeds of which are to be used to provide air pollution control facilities.

In the instant case, the dock used by the corporation for loading and unloading the grain elevator is located within and is a part of a public port. Thus, as provided in section 1.103-8(e)(1) of the regulations, the dock satisfies the public use requirements.

Since the grain elevator is a storage facility located adjacent to the dock and is directly related to the dock operation, it qualifies as a storage facility within the meaning of section 103(c)(4)(D) of the Code. The new grain handling facilities to be financed by the bond proceeds will perform essential functions in the basic operation of the elevator and will be functionally related and subordinate to the dock. Thus, such proposed facilities will qualify as a dock or related storage facilities and the exception provisions of section 103(c)(4)(D) will apply to the proposed industrial development bonds whether or not such facilities qualify as air pollution control facilities under section 103(c)(4)(F).

Accordingly, the interest on bonds to be issued by the political subdivision will be excludable from the gross incomes of the bondholders under the provisions of section 103(a)(1) of the Code.

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26 CFR 1.103-8: Interest on bonds to finance certain exempt facilities.

Industrial development bonds; water facility used primarily by nonexempt person. The proposed use by two nonexempt manufacturing firms of 80 percent of the output of a water facility to be built by a political subdivision does not meet the public use requirement of section 1.103-8(a)(2) of the regulations.

Rev. Rul. 76-494

Advice has been requested whether, under the circumstances described be-

low, a certain facility for the furnishing of water will meet the public use requirement of section 1.103-8(a)(2) of the Income Tax Regulations.

M, a political subdivision of a state, proposes to issue industrial development bonds as described in section 103(c)(2) of the Internal Revenue Code of 1954, the proceeds of which will be used to construct a facility for the furnishing of water to industrial, commercial, and domestic users. Two persons, *O* and *P*, who are not exempt persons within the meaning of section 103(c)(3), each of whom is engaged in a manufacturing business, entered into contracts with *M* under which they have the right to use a maximum of 80 percent of the water from the facility. Any water not used by *O* and *P* will be available to the general public and will be sufficient to satisfy the public's water consumption needs.

Section 103(a)(1) of the Code provides, in part, that gross income does not include interest on obligations of states and political subdivisions thereof.

Section 103(c)(1) of the Code provides, in part, that industrial development bonds shall not be treated as obligations of states and political subdivisions thereof.

However, section 103(c)(4)(G) of the Code provides, in part, that the provisions of section 103(c)(1) shall not apply to any obligation that is issued as part of an issue substantially all of the proceeds of which are used to provide certain exempt facilities including facilities for the furnishing of water if the water is available on reasonable demand to members of the general public. Section 1.103-8(a)(2) of the regulations provides, in part, that to qualify as an exempt facility for purposes of section 103(c)(4) of the Code, the facility must serve or be available on a regular basis for general public use as contrasted with similar types of facilities that are constructed for the exclusive use of a limited number of nonexempt persons in their trades or businesses.

Section 1.103-8(h)(1) of the regulations provides, in part, that a water facility will satisfy the public use requirement of section 1.103-8(a)(2) if such facility will provide water, on reasonable demand, to any member of the general public within the service area of the water system of which such facility is a part.

The determination of whether a water facility will provide water, on reasonable demand, to any member of the general public within the service area of the water system of which such facility is a part must be determined by reference to the amount of water available to the general public as compared with the amount of water available to the limited number of nonexempt users in their trades or businesses. Thus, merely serving a large number of members of the general public does not satisfy the public use requirement when the aggregate amount of water available to such members of the general public is small in comparison with the amount of water available for use by the limited number of nonexempt persons in their trades or businesses.

In the instant case, the aggregate amount of water available to the general public is small (20 percent of capacity) in comparison with the amount of water available (80 percent of capacity) for use by *O* and *P*, a limited number of nonexempt persons, in their trades or businesses.

Accordingly, the water facility will not meet the public use requirement of section 1.103-8(a)(2) of the regulations.

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26 CFR 1.103-10: Exemption for certain small issues of industrial development bonds.

Industrial development bonds; exempt small issue; revocation of election. A political subdivision of a state that issued industrial development bonds in the amount of $1,000,000 to finance the acquisition of facilities for use by a nonexempt industrial corporation that plans to pay or incur capital expenditures of $4,500,000 from its own funds on the facilities within three years of the issue date of the bonds may not revoke a previously made election to have the bonds treated as a $5,000,000 exempt small issue.

Rev. Rul. 76-375

Advice has been requested whether, under the circumstances described below, a political subdivision of a state may revoke a previously made election to have its industrial development bonds treated as a $5,000,000 exempt small issue.

The political subdivision filed a statement with the director of the appropriate regional service center electing to treat a proposed issue of industrial development bonds as a $5,000,000 exempt small issue as provided for in section 103(c)(6)(D) of the Internal Revenue Code of 1954 and section 1.103-10(b)(2)(vi)(*a*) of the Income Tax Regulations.

Subsequent to the filing of the election statement, the political subdivision issued industrial development bonds in the face amount of $1,000,000 to finance the acquisition of facilities for use by a nonexempt industrial corporation. There were no prior exempt small issues outstanding at the time the bonds were issued and no capital expenditures had been paid or incurred with respect to the financed facilities by the political subdivision or by the corporation during the three-year period prior to the issuance of the bonds. The corporation did not own or operate any facilities in the political subdivision prior to the issuance of the bonds. At the time of issuance, it was anticipated that additional industrial development bonds would be issued to finance more facilities for the corporation.

The anticipated additional bonds were not issued and now the political subdivision does not plan to issue any future bonds with respect to facilities used by the corporation. However, the corporation is scheduled to pay or incur capital expenditures of $4,500,000 from its own funds with respect to the facilities within three years of the issue date of the bonds. The political subdivision now desires to revoke the previous election to treat the bonds as an exempt small issue of $5,000,000 and reclassify the bonds as a $1,000,000 exempt small issue under section 103(c)(6)(A) of the Code since the scheduled capital expenditures by the corporation would not affect the tax-exempt status of the interest on a $1,000,000 exempt small issue.

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state, a territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.

Section 103(c)(1) of the Code provides that, except as otherwise provided in section 103(c), any industrial development bond shall be treated as an obligation that is not an obligation described in section 103(a)(1).

Section 103(c)(6)(A) of the Code provides, in part, that section 103(c)(1) shall not apply to any obligation issued as part of an issue the aggregate authorized face amount of which is $1,000,000 or less.

Section 103(c)(6)(D) of the Code provides, in part, that the issuer may elect to issue an exempt small issue of $5,000,000 or less in lieu of the $1,000,000 described in section 103(c)(6)(A). In determining the aggregate face amount of such issue, certain capital expenditures incurred during the six year period beginning three years before and ending three years after the date of such issue must be taken into account.

Section 1.103-10(b)(2)(ii) of the regulations provides that an expenditure is a capital expenditure if, among other things, it was properly chargeable to the capital account and if it was paid or incurred during the six year period that begins three years before the date of issuance of the issue in question and ends three years after that date.

Section 1.103-10(b)(2)(vi)(*a*) of the regulations provides, in part, that the issuer may make the election provided by section 103(c)(6)(D) of the Code by means of a statement signed by a duly authorized official that the governmental unit elects to have the provisions as to the $5,000,000 limit in section 103(c)(6)(D) apply to an issue of industrial development bonds. The statement must be filed prior to the issuance of the bonds with the district director or director of the regional service center with whom the principal user or users of the proceeds of such issue, or facilities acquired, constructed, reconstructed, or improved with the proceeds of such issue, are required to file their income tax returns for the taxable year during which the election is made.

The District Court, in *Bay Sound Transportation Co. v. United States*, 67-2 U.S.T.C. 9641 (S.D. Tex. 1967), *aff'd, rev'd,* and *rem'd,* 410 F.2d 505 (5th Cir. 1969), *cert. denied,* 396 U.S. 928 (1969), held that the taxpayer made a binding election not to claim the benefits of section 248 of the Code, relating to amortization of organization expenditures, by not complying with the express election requirements in the statute and regulations. In discussing the consequences of making an election, the court stated:

> The doctrine of election applies where, as here, a taxpayer is given a choice of either taking one or two courses of action; once there has been a clear exercise of the choice as shown by some act or failure to act, the election is binding on the taxpayer. An oversight, an error of judgment, or unawareness of tax consequences does not lessen the binding character of the election. See Mertens, Federal Income Taxation, Sections 60.19-60.20 (1959); *Ross v. Commissioner,* 169 F.2d 483, 493 (C.A. 1st 1948); *Alabama Pipe Co. v. Commissioner,* 23 T.C. 95, 98 (1954); *Thorrez v. Commissioner,* 31 T.C. 655, 668 (1958) *aff'd,* 272 F.2d 945 (C.A. 6th).

In the instant case, the political subdivision made a timely election under section 103(c)(6)(D) of the Code and section 1.103-10(b)(2)(vi)(*a*) of the regulations with respect to the treatment of its industrial development bonds. These sections do not contain any provision for rescinding the election. Thus, since the political subdivision clearly exercised a choice when it made the election, such election is binding regardless of the subsequent consequences. *Bay Sound Transportation Co.*

In addition to the above, allowing a political subdivision to rescind its $5,000,000 election would provide a route whereby the capital expenditures rule of section 103(c)(6)(D) of the Code and section 1.103-10(b)(2)(ii) of the regulations could be avoided under circumstances such as those in the instant case.

Accordingly, the political subdivision may not revoke its previously made election to have its industrial development bonds treated as a $5,000,000 exempt small issue.

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26 CFR 1.103-10: Exemption for certain small issues of industrial development bonds.

Industrial development bonds; small issues; integrated facilities located in different jurisdictions. Industrial development bonds separately issued by a county and a city within the county to finance, for use by the same corporation, noncontiguous factories located one-half mile apart with one factory producing carpet yarn for the manufacture of carpets in the other so that they are integrated facilities within the meaning of section 1.103-10(b)(2)(ii)(e) of the regulations, must be aggregated and considered with capital expenditures to determine whether the $5,000,000

exempt small issue limitation has been exceeded.

Rev. Rul. 76-427

Advice has been requested whether, under the circumstances described below, certain prior issues and capital expenditures must be taken into account in determining the aggregate face amount of exempt small issues of governmental obligations as provided in section 103(c)(6)(D)(ii) of the Internal Revenue Code of 1954.

On January 2, 1975, county *M* issued bonds with a face amount of $2,000,000 to finance the acquisition of a factory located in the county, but not within any incorporated municipality. The factory abuts the boundary line of city *P*, an incorporated municipality located entirely within the county. The equitable owner and sole user of the factory is corporation *X*, a nonexempt person. *X* utilizes the factory to manufacture yarn of the type that is suitable for the manufacture of carpets. All of the yarn produced in the factory is used by *X* in its manufacture of carpets.

The bonds issued by *M* are industrial development bonds within the meaning of section 103(c)(2) of the Code. Prior to the issuance of the bonds, *M* made an election under section 103(c)(6)(D) to treat the bonds as an exempt small issue of $5,000,000 or less. *M* had not previously issued an exempt small issue to finance facilities for the use of *X* or a related person.

On June 2, 1975, *P* issued bonds with a face amount of $1,500,000 to finance the acquisition of a factory located within the city about one-half mile from the location of the yarn factory. Neither the factory in *P* nor the land upon which it is located abuts the city-county boundary line. The equitable owner and sole user of the factory is *X*. The factory is used by *X* to manufacture carpets from the yarn produced by the yarn factory located in *M*. The yarn is transported to the carpet factory by truck. The factories in *M* and *P* are each designed to function as integral units in the continuous manufacturing process of changing raw materials into finished products (carpets).

The bonds issued by *P* are industrial development bonds within the meaning of section 103(c)(2) of the Code. Prior to the issuance of the bonds, *P* made an election under section 103(c)(6)(D) to treat the bonds as an exempt small issue of $5,000,000 or less. *P* has not previously issued an exempt small issue to finance facilities for the use of *X* or a related person. At the time of issuance of these bonds, the full face amount of the *M* bonds ($2,000,000) was still outstanding.

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state, a territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.

Section 103(c)(1) of the Code provides that the section 103(a)(1) exemption from taxation is not available with respect to industrial development bonds unless subject to one of the specific exceptions provided in section 103(c).

Section 103(c)(6)(A) of the Code provides that section 103(c)(1) does not apply to a small issue of $1,000,000 or less. However, the aggregate face amount of the bond issue will be determined, for purposes of resolving whether the $1,000,000 limit has been exceeded, by taking into account the face amount of any prior issues that are exempt under section 103(c)(6) and that are issued to finance facilities of the type described in section 103(c)(6)(E). The prior bond issue will be taken into account only to the extent still outstanding at the time of the later issuance.

At the election of the issuer, the small issue exemption is available to an issuance of $5,000,000 or less as provided in section 103(c)(6)(D) of the Code. However, if this election is made, the aggregate face amount of the bond issue will be determined, for purposes of resolving whether the $5,000,000 limit has been exceeded, by taking into account the face amount of prior issues discussed above and any capital expenditures made with respect to facilities of the type described in section 103(c)(6)(E) and paid or incurred three years before or after the issuance of the bonds in question (and financed otherwise than out of the proceeds of a prior exempt issue already being taken into account).

The facilities described in section 103(c)(6)(E) of the Code are those of which the principal user is the same person as the principal user of the facilities financed by the bonds in question or a person related thereto, provided that both facilities are located in the same incorporated municipality or the same county (but not in any incorporated municipality).

Section 1.103-10(d)(2) of the Income Tax Regulations provides that an outstanding prior exempt small issue that was issued on or after August 8, 1972, with respect to a contiguous or integrated facility located on both sides of a border between two or more political jurisdiction shall be taken into account in determining whether the small issue exemption limits have been exceeded in all future issuances by either political jurisdiction if the principal user of the financed facilities is the same person or two or more related persons.

Section 1.103-10(b)(2)(ii)(e) of the regulations provides that with respect to obligations issued on or after August 8, 1972, capital expenditures made with respect to a contiguous or integrated facility located on both sides of a border between two or more political jurisdictions shall be considered made with respect to a facility located in all such jurisdictions and, therefore, shall be treated as if made

in each political jurisdiction if the capital expenditure was financed other than out of the proceeds of issues already taken into account under section 1.103-10(b)(2)(i)(a), if the expenditures were paid or incurred during the 6-year period beginning three years before and ending three years after the date of issuance of the issue in question, and if the principal user of the facilities is the same person or two or more related persons.

In determining whether two facilities are integrated for purposes of sections 1.103-10(b)(2)(ii)(e) and 1.103-10(d)(2) of the regulations, the involvement of the two facilities in various stages of the same overall continuing manufacturing process is significant. Another factor to consider is whether or not the facilities are located in the same proximity. In the instant case, the factory located in *M* and the factory located in *P* are dependent upon each other for completion of the manufacturing process since each is an essential unit in the manufacture of carpets. In addition, since both factories are located within one-half mile of each other, they are located in the same proximity.

Accordingly, in this case, the two facilities are integrated for purposes of sections 1.103-10(b)(2)(ii)(e) and 1.103-10(d)(2) of the regulations. Thus, in determining the aggregate face amount of the bonds issued by *M*, the $1,500,000 capital expenditure paid or incurred with respect to the acquisition of the carpet factory located in *P* must be added to the $2,000,000 face amount of the *M* issue. Any capital expenditures paid or incurred three years before or after January 2, 1975, with respect to facilities located in *M*, of which the principal user is *X* or a related person, must be taken into account. In addition, any capital expenditures paid or incurred with respect to the integrated facility located in *P* during the applicable 6-year period that are not otherwise taken into account in the acquisition cost must be taken into account in determining the aggregate face amount of the *M* bond issue.

In determining the aggregate face amount of the bonds issued by *P*, the $2,000,000 outstanding face amount of the prior exempt small issue of *M* must be added to the $1,500,000 face amount of the *P* issue. Any capital expenditures paid or incurred three years before or after June 2, 1975, with respect to facilities located in *P*, of which the principal user is *X* or a related party, must be taken into account. In addition, any capital expenditures paid or incurred with respect to the integrated facility located in *M* during the applicable 6-year period not otherwise taken into account as an outstanding prior exempt issue must be taken into account in determining the face amount of the *P* bond issue.

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26 CFR 1.103-11: Bonds held by substantial users.

Industrial development bonds; substantial users. Members of a tax-exempt farmers' cooperative who purchase industrial development bonds, issued as an exempt small issue by a political subdivision of a state to finance the construction of a slaughterhouse and marketing facility to be leased to the cooperative for the benefit of the members, none of whom will derive gross revenue in excess of five percent of the total revenue or occupy more than five percent of the usable space of the facilities, are considered "substantial users" of the facilities for purposes of section 103(c)(7) of the Code and section 1.103-11 of the regulations.

Rev. Rul. 76-406

Advice has been requested whether, under the circumstances described below, members of a farmers' cooperative will be considered "substantial users" of the cooperative facilities for purposes of section 103(c)(7) of the Internal Revenue Code of 1954 and section 1.103-11 of the Income Tax Regulations.

A political subdivision of a state proposes to issue industrial development bonds in the amount of $2,000,000 to finance the construction of a slaughterhouse and marketing facility to be leased to a farmers' cooperative that has been held to be exempt from Federal taxation under section 521 of the Code. Prior to the issuance of the bonds, the political subdivision will elect to apply the provisions of section 103(c)(6)(D) to the bond issue in order that it will qualify as an exempt small issue of $5,000,000 or less. Initially, the bonds will be offered to the members of the farmers' cooperative.

The farmers' cooperative was formed for the purpose of coordinating the efforts of local farmers in the production and marketing of livestock. The farmers' cooperative has approximately 3,000 members. In order to be a member of the cooperative, a person must acquire a minimum of 15 shares of preferred stock of the cooperative and at least one share of common stock. The common stock must be held by persons engaged in the production of agricultural commodities, including livestock.

The slaughterhouse and marketing facility will be operated by the farmers' cooperative for the benefit of the members who will deliver cattle to the facilities for slaughtering or marketing. No member will derive gross revenue from the cooperative facilities that is in excess of five percent of the total revenue derived by all users of the cooperative facilities, and no member will occupy more than five percent of the entire usable space of the facilities.

Section 103(a)(1) of the Code provides that gross income does not include interest on the obligations of a state, a territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia.

Section 103(c)(1) of the Code pro-

vides that, except as otherwise provided in section 103(c), any industrial development bond shall be treated as an obligation that is not an obligation described in section 103(a)(1).

When used with respect to industrial development bonds, the term "exempt person" means a governmental unit or an organization described in section 501(c)(3) of the Code.

Section 103(c)(6)(D) of the Code provides, in part, that, at the election of the issuer, section 103(c)(1) shall not apply to an exempt small issue of $5,000,000 or less.

Section 103(c)(7) of the Code provides, in part, that the exception provisions for exempt small issues under section 103(c)(6)(D) shall not apply with respect to any obligation for any period during which it is held by a person who is a substantial user of the facilities financed with bond proceeds or by a related person.

Section 1.103-11(a) of the regulations provides, in part, that the interest paid on an exempt small issue of industrial development bonds is includible in the gross income of a substantial user (or related person) for any period during which such obligation is held by such user (or related person).

Section 1.103-11(b) of the regulations provides, in part, that a substantial user of a facility includes any nonexempt person who regularly uses a part of such facility in a trade or business. However, unless a facility, or a part thereof, is constructed, reconstructed, or acquired specifically for a nonexempt person or persons, such a nonexempt person shall be considered to be a substantial user of a facility only if (1) the gross revenue derived by such user with respect to such facility is more than five percent of the total revenue derived by all users of such facility or (2) the amount of area of the facility occupied by such user is more than five percent of the entire usable area of the facility.

Example (3) in section 1.103-11(c) of the regulations illustrates that each of 30 physicians and dentists leasing equal amounts of the total office space in a medical building financed by an exempt small issue of industrial development bonds will be a substantial user of the facility since the facility will be constructed specifically for such physicians and dentists.

Under the facts in the instant case the facilities will be constructed specifically for the members of the farmers' cooperative to use as a slaughterhouse and marketing facility in their trade or business of farming. Therefore, it is immaterial that no member will derive gross revenue from the facilities that will be more than five percent of the total revenue derived by all users of such facilities, and that no member will occupy more than five percent of the space of such facilities.

Accordingly, the members of the farmers' cooperative will be substantial users of the slaughterhouse and marketing facility for purposes of section 103(c)(7) of the Code and section 1.103-11 of the regulations. Interest to be received on the bonds held by such substantial users will be includible in their gross incomes.

Section 105.—Amounts Received Under Accident and Health Plans

26 CFR 1.105-4: Wage continuation plans.

Sick pay exclusion; mandatory retirement age; certain law enforcement officers and firefighters employed by the U.S. Government. The mandatory retirement age for purposes of the sick pay exclusion provisions of section 105(d) of the Code is set forth for law enforcement officers and firefighters whose retirement age is governed by 5 U.S.C.A. section 8336, in view of its amendment by Pub. L. No. 93-350, which was enacted on July 12, 1974, and is to become effective on January 1, 1978; Rev. Rul. 66-182 is superseded.

Rev. Rul. 76-343

The Internal Revenue Service has been asked to state its position concerning the time at which certain employees of the United States Government reach mandatory retirement age for purposes of determining whether the disability pension payments they receive are sick pay that is excludable from gross income under section 105(d) of the Internal Revenue Code of 1954.

The employees in question are those referred to in sections 8335(g) and 8336(c) of title 5 of the United States Code, as those sections were added and amended, respectively, by Public Law 93-350, which was enacted on July 12, 1974, and is to become effective on January 1, 1978.

Subsection (g), as added to section 8335 of 5 U.S.C. by Public Law 93-350, provides, in part, that law enforcement officers and firefighters who are otherwise eligible for immediate retirement under 5 U.S.C. section 8336(c) shall be separated from the service on the last day of the month the employee becomes 55 years of age or completes 20 years of service if then over that age. The head of the agency, when in his or her judgment the public interest so requires, may exempt such an employee from automatic separation until the employee becomes 60 years of age.

Subsection (c) of 5 U.S.C. section 8336, as amended by Public Law 93-350, provides that an employee who is separated from the service after becoming 50 years of age and completing 20 years of service as a law enforcement officer or firefighter, or any combination of such service totaling at least 20 years, is entitled to an annuity.

Section 8335(a) of 5 U.S.C. (Supp. III, 1973) provides that, except as otherwise provided by section 8335, an employee who becomes 70 years of age and completes 15 years of service shall be automatically separated from government service. The separation is effective on the last day of the month

in which the employee becomes 70 years of age or completes 15 years of service if then over that age.

However, section 8335(d)(1) states that these automatic separation provisions do not apply to an employee named by a statute providing for that employee's continuance in the service, and section 8335(c) authorizes the President, by Executive order, to similarly exempt from automatic separation an employee whose continuance is warranted in the public interest.

The specific question presented is what is the mandatory retirement age, for purposes of the sick pay exclusion provisions of section 105(d) of the Code, for a law enforcement officer or firefighter otherwise eligible for immediate retirement under 5 U.S.C.A. section 8336(c) (Supp.1975) either—

(A) if the individual is retired for disability before January 1, 1978; or

(B) if the individual is retired for disability on or after January 1, 1978.

Section 105(a) of the Code provides that amounts received by an employee through accident or health insurance for personal injuries or sickness are includible in gross income to the extent such amounts are attributable to contributions by the employer that were not includible in the gross income of the employee, or are paid by the employer.

An exception to this general rule is provided by section 105(d) of the Code. Section 105(d) states, in part, that gross income does not include amounts referred to in section 105(a) if such amounts constitute wages or payments in lieu of wages received by an employee for a period during which the employee is absent from work on account of personal injuries or sickness.

Section 1.105-4(a)(3)(i)(A) of the Income Tax Regulations provides, in part, that section 105(d) of the Code applies only to amounts attributable to periods during which the employee would be at work were it not for a personal injury or sickness. Thus, an employee is not absent from work if the employee is not expected to be at work because, for example, the employee has reached mandatory retirement age.

Section 1.105-4(a)(3)(i)(B) of the regulations provides that the term "mandatory retirement age" means (with exceptions not here relevant) the age set by the employer for the mandatory retirement of employees in the class to which the taxpayer last belonged.

Rev. Rul. 66-182, 1966-2 C.B. 36, holds that an annuity received by certain employees of the United States Government retired for length of service at age 50 with 20 years of qualifying "hazardous" service, under section 6(c) of the Civil Service Retirement Act of May 29, 1930 (now amended and codified as 5 U.S.C.A. section 8336(c) (Supp. 1975)), is not a disability pension under a wage continuation plan within the meaning of section 105(d) of the Code. This position is here reaffirmed.

Based on the foregoing, for purposes of determining whether the disability pension payments the individual receives are sick pay that is excludable from gross income under section 105(d) of the Code, the mandatory retirement age of a law enforcement officer or firefighter otherwise eligible for immediate retirement under 5 U.S.C.A. section 8336(c) (Supp. 1975) and not excluded from the automatic separation provisions under 5 U.S.C. section 8335(c) or 8335(d)(1), is the age at which the individual would become subject to mandatory retirement, had the individual not suffered the disabling injury or sickness and had continued as a full-time employee. In making this determination, any changes in the retirement plan that would have affected the individual's mandatory retirement age had there not been an early retirement by reason of disability, must be taken into account. This rule may be illustrated as follows:

(A) If retired for disability before January 1, 1978, the individual reaches mandatory retirement at the times set forth below:

(1) at age 70 with 15 years of service if the individual has reached that age-service combination before January 1, 1978; or

(2) on January 1, 1978, if the individual has not reached the above age-service combination but has reached age 55 with 20 years of service before that time; or

(3) at age 55 with 20 years of service if the individual has not reached that age-service combination before January 1, 1978.

(B) If retired for disability on or after January 1, 1978, the individual reaches mandatory retirement at age 55 with 20 years of service, as provided by 5 U.S.C.A. section 8335(g) (Supp. 1975).

For purposes of applying the above rules, in the case of employees receiving disability pension payments, the period of service shall be computed by adding to periods of actual service as a federal law enforcement officer or firefighter those periods for which disability pension payments were received for disabilities arising while so employed. Furthermore, mandatory retirement age is reached on the last day of the month in which the individual achieves the specified age-service combination.

These holdings are not affected by the fact that the individual, at the time of the disability retirement, may be eligible for optional retirement because of being at least 50 years of age with 20 years of service, as provided by 5 U.S.C.A. section 8336(c) (Supp. 1975), or by the fact that the head of the agency has the discretionary power to exempt an employee from automatic separation until the employee becomes 60 years of age.

Rev. Rul. 66-182 is superseded since the position stated therein is restated under the current statute and regulations in this Revenue Ruling.

Section 112.—Certain Combat Pay of Members of the Armed Forces

Treatment of amounts withheld or deducted from the compensation of any individual who died while in active service in a combat zone as a member of the Armed Forces. See Sev. Rul. 76-355, page 201.

Date of death, for members of the Armed Forces of the United States who are prisoners of war or missing in action, for purposes of determining the tax treatment, under section 112(d) of the Code, of compensation for active service during missing status. See Rev. Rul. 76-468, page 202.

Section 117.—Scholarships and Fellowship Grants

26 CFR 1.117-1: Exclusion of amounts received as a scholarship or fellowship grant.

Scholarships and fellowships; state promotion of energy-related studies. Grants awarded by a state agency, responsible for promoting energy-related studies within the state, to state residents for energy-related courses of study that they are required to pursue full-time and who may be called upon to furnish progress reports, but who are not required to remain in the state or work in the energy field after completion of their courses, qualify as scholarships or fellowship grants under section 117 of the Code.

Rev. Rul. 76-251

Advice has been requested whether, under the circumstances described below, grants made by a state agency to promote energy-related studies qualify as scholarships and fellowship grants excludable from the recipients' gross income under section 117 of the Internal Revenue Code of 1954.

A state agency has the responsibility of developing and promoting energy and energy-related educational programs within the state. In order to carry out the programs, the agency awards a certain number of academic scholarships, academic scholarships for demonstrated need, and fellowship grants on a state-wide basis.

In order to qualify for a scholarship, a student must (1) be a resident of the state, (2) be a high school graduate prior to the date of admission to an accredited educational institution, (3) rank above average academically in the student's high school class, and (4) be accepted for admission to an accredited educational institution within the state and into a degree-program that is energy-related. A student who wishes to apply for a "demonstrated need" scholarship must meet all the above requirements as well as the requirements for financial aid recipients established by the educational institution where the student plans to pursue a degree.

In order to qualify for a fellowship grant an individual must (1) be a resident of the state, (2) be currently or recently employed in the state (the individual cannot be presently enrolled full-time in school), (3) hold a bachelor's degree, preferably in a scientific or engineering field, and (4) be willing to devote full time to the program.

Information regarding the scholarships and fellowship grants is conveyed to potential applicants through school counselors, major employers in the state, and community agencies.

Applicants for a scholarship or a fellowship grant must apply to the state agency and must submit information including a résumé of their personal and educational background, an outline of the educational program or energy-related course of study they plan to pursue, and three letters of recommendation. Applicants for a scholarship must also submit information describing their career goals and explain how they feel their educational program and career goals will contribute to their ability to work in an energy field.

Applications are screened and recipients of scholarships and fellowship grants are determined by a selection committee, the members of which are not employees of the state agency, but are individuals from various educational institutions in the state.

Selection of recipients is made primarily on the basis of (1) academic rank compared to other applicants, (2) applicability of the individual's proposed program to the energy field, and (3) letters of recommendation. In the case of fellowship grants consideration is also given to a subjective assessment of how likely the recipient is to remain in the state.

When a scholarship is awarded to an individual, the state agency makes tuition payments directly to the educational institution that the student is attending. When a fellowship is awarded, the state agency makes monthly payments directly to each individual.

All recipients are obligated to pursue their programs on a full-time basis and to complete the programs they have outlined. There is no obligation that the recipients must remain in the state or work in the energy field after they complete their programs. The recipients are free to work for whomever they wish and at any location they choose.

Scholarship and fellowship recipients may be called upon from time to time to meet with state legislators to inform them of the progress of their studies. These meetings are purely to give the legislators some idea of how well the money appropriated for the programs is being spent.

Subject to certain qualifications and limitations, section 117(a) of the Code provides that, in the case of an individual, gross income does not include any amount received as a scholarship at an educational institution or as a fellowship grant. A scholarship or fellowship grant is an amount paid or allowed to an individual to aid such individual in the pursuit of study or research.

Section 117(b)(2) of the Code provides, in part, that individuals who are not candidates for a degree at an educational institution (as defined in section 151(e)(4)) are subject to a limi-

tation of $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year. This exclusion is allowed for a maximum period of 36 months, whether or not consecutive.

Section 1.117-4(c) of the Income Tax Regulations provides, in part, that any amounts paid or allowed to, or on behalf of, an individual to enable the individual to pursue studies or research shall not be considered to be an amount received as a scholarship or fellowship grant if such amount represents compensation for past, present or future employment services, if such amount represents payment for services that are subject to the direction or supervision of the grantor, or if such studies or research are primarily for the benefit of the grantor. Any of these conditions will negate the existence of a scholarship or fellowship grant as defined in these regulations. However, neither the fact that the recipient is required to furnish progress reports to the grantor, nor the fact that the results of the studies or research may be of some incidental benefit to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

In the instant case, the recipients are not subject to the direction or supervision of the grantor, nor are they in any way obligated to perform services for the grantor before, during or after receiving the scholarships or fellowship grants. Moreover, the grants are not made to enable the recipients to pursue studies or research primarily for the benefit of the grantor.

Accordingly, the grants made by the state agency qualify as scholarships or fellowship grants that are excludable from the gross income of the recipients under section 117 of the Code. However, with respect to any recipient who is not a candidate for a degree, the amount excludable is subject to the $300 per month limitation and only to the extent that the recipient has not exhausted the 36-month lifetime exclusion, as provided in section 117 (b)(2).

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26 CFR 1.117-1: Exclusion of amounts received as a scholarship or fellowship grant.

Grant from National Endowment for the Humanities. Amounts granted a college professor, not a candidate for a degree, from the National Endowment for the Humanities for a two-month study on the interaction of the sciences and literature, with a view toward writing a book in which the grantor retains no publishing rights, is excludable from the recipient's gross income as a fellowship grant; Rev. Rul. 74-95 distinguished.

Rev. Rul. 76-351

Advice has been requested whether, under the circumstances described below, an amount received as a grant is excludable from the taxpayer's gross income under section 117(a) of the Internal Revenue Code of 1954.

The taxpayer, who was not a candidate for a degree, applied for and was granted a lump-sum grant for two months from the National Endowment for the Humanities, a governmental agency. The taxpayer was a professor of English literature and proposed to spend the two-month grant period studying the interaction of the sciences and literature with a view towards writing a book on the taxpayer's conclusions.

As a condition to receiving the grant the taxpayer was to devote two full consecutive months during the summer to the study and research for which the grant was awarded. The taxpayer was not permitted to accept a teaching assignment, undertake another major activity, or enroll in a degree program during the two-month period and was prohibited from applying the work done during that period toward any future degree. The taxpayer was not required to publish the results of the study but was free to do so without restriction. If the taxpayer chose to publish the results of the study, the grantor requested, but did not require, a copy of the publication and advance notice thereof so that it could consider issuing a public information release or cooperating in a joint release.

Section 117(a) of the Code provides, subject to certain limitations and qualifications, that gross income of an individual does not include amounts received as a scholarship at an educational institution or as a fellowship grant. A scholarship or fellowship grant as defined in section 1.117-3 of the Income Tax Regulations is an amount paid to or for the benefit of an individual to aid in the pursuit of study or research.

Section 117(b)(2) of the Code limits the exclusion provided for by section 117(a), in the case of an individual who is not a candidate for a degree, to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during the taxable year, subject to a lifetime limitation of 36 months, whether or not consecutive.

Section 1.117-4(c) of the regulations provides, in part, that any amount or amounts paid or allowed to or on behalf of an individual to enable the individual to pursue studies or research shall not be considered to be an amount received as a scholarship or fellowship grant, if such amount represents compensation for past, present, or future employment services, if such amount represents payment for services that are subject to the direction or supervision of the grantor, or if the studies or research are primarily for the benefit of the grantor. Any of these conditions will negate the existence of a scholarship or fellowship grant as defined in the regulations.

A grant to an individual to enable the individual to pursue a program of research, interpretation, or original

thought, however, qualifies under the definition of a "fellowship grant" contained in section 1.117-3(c) of the regulations as "an amount paid or allowed to or for the benefit of an individual to aid in the pursuit of studies or research." See Rev. Rul. 72-163, 1972-1 C.B. 26, and Rev. Rul. 72-168, 1972-1 C.B. 37.

In this case, the grant was paid to enable the taxpayer to pursue a program of independent study. The grantor reserved no publication rights. Since the grant was awarded solely to further the education of the taxpayer, it was for the taxpayer's benefit and not for the benefit of the grantor. Further, there was no employment relationship between the grantor and the taxpayer previous to or at the time of the grant, nor was there any obligation on the part of the taxpayer to accept employment or otherwise perform services after acceptance of the grant.

Accordingly, in the instant case, the grant received from the National Endowment for the Humanities is excludable from the taxpayer's gross income as a fellowship grant under section 117(a) of the Code, subject to the limitations provided in section 117(b)(2).

This case is distinguishable from Rev. Rul. 74-95, 1974-1 C.B. 39, which holds that amounts received as a grant from the National Endowment for the Humanities are not excludable from the taxpayer's gross income under section 117(a) of the Code. In Rev. Rul. 74-95, the grantor reserved a nonexclusive license to use and reproduce for government purpose, without payment, any publishable matter, including copyrighted matter arising out of the taxpayer's activities, and the objectives of the program under which the grant was awarded were not solely focused on the experience to be gained by the recipients.

Rev. Rul. 74-95 is distinguished.

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26 CFR 1.117-1: Exclusion of amounts received as a scholarship or fellowship grant.

Fellowship grant; medical research. A one-year grant received for original research in a particular field of medicine by a medical student, who took leave of absence from school, received no academic credit for the research, was required to submit a report, was required to acknowledge the grantor's financial support in the event the research results were published, and was not obligated to accept employment with or perform services for the grantor, is excludable from gross income as a fellowship grant subject to the limitations of section 117(b)(2) of the Code.

Rev. Rul. 76-463

Advice has been requested whether, under the circumstances described below, an amount received as a grant is excludable from the taxpayer's gross income under section 117(a) of the Internal Revenue Code of 1954.

The taxpayer received a grant for a one-year period from a medical foundation, an organization described in section 501(c)(3) of the Code that is exempt from tax under section 501(a). The grant is awarded to individuals who are interested in research and teaching careers in a particular field of medicine and who agree to devote their full time for an entire year to a specific research project of their design in that field. A candidate for the grant must be enrolled in a medical school, must have completed at least one year of the school curriculum, and must be sponsored by the medical program of the institution at which the research project is to be undertaken. The sponsoring institution administers the grant and must submit a statement concerning the use of the funds at the end of the grant period.

The taxpayer was not subject to control or direction by the grantor. The terms of the grant merely required that the research be original, that the taxpayer submit a report upon completion of the research project, and that the grantor's financial support be acknowledged in the event that the taxpayer chooses to publish the results of the research. The research was conducted at a university and was supervised by physician-instructors who were neither supported by nor associated with the grantor. The taxpayer had never been employed by the grantor, and no future employment obligation was required of the taxpayer. The taxpayer took a one-year leave of absence from the medical school in which the taxpayer had been enrolled, received no academic credit for the research and, therefore, was not a degree candidate during the grant period.

Section 117(a)(1) of the Code provides that gross income of an individual does not include amounts received as a scholarship at an educational institution or as a fellowship grant. A scholarship or fellowship grant as defined in section 1.117-3 of the Income Tax Regulations is an amount paid to or for the benefit of an individual to aid in the pursuit of study or research.

In the case of an individual who is not a candidate for a degree, section 117(b)(2) of the Code limits the exclusion provided for by section 117(a) to the grantees of certain grantors, one of which is an organization described in section 501(c)(3) that is exempt from tax under section 501(a), and to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during the taxable year, subject to a lifetime limitation of 36 months, whether or not consecutive.

Section 1.117-4(c) of the regulations provides, in part, that any amount or amounts paid or allowed to or on behalf of an individual to enable the individual to pursue studies or research shall not be considered to be an amount received as a scholarship or fellowship grant, if such amount represents compensation for past, present, or future employment services, if such amount represents payment for services that are

subject to the direction or supervision of the grantor, or if the studies or research are primarily for the benefit of the grantor. Any of these conditions will negate the existence of a scholarship or fellowship grant as defined in the regulations. The fact that the recipient is required to furnish progress reports to the grantor does not destroy the essential character of a grant as a scholarship or fellowship grant.

A grant to an individual to enable the individual to pursue a program of research is a "fellowship grant" within the meaning of section 1.117-3(c) of the regulations as "an amount paid or allowed to or for the benefit of an individual to aid in the pursuit of studies or research." See Rev. Rul. 72-163, 1972-1 C.B. 26, and Rev. Rul. 72-168, 1972-1 C.B. 37.

In this case, the grant was paid to enable the taxpayer to pursue a program of independent research, and the grantor reserved no publication rights. Since the grant was awarded solely to further the education of the taxpayer, it was for the taxpayer's benefit and not for the benefit of the grantor. Further, there was no employment relationship between the grantor and the taxpayer previous to or at the time of the grant, nor was there any obligation on the part of the taxpayer to accept employment or otherwise perform services after acceptance of the grant.

Accordingly, in the instant case, the grant received from the foundation is excludable from the taxpayer's gross income as a fellowship grant under section 117(a) of the Code, subject to the limitations provided in section 117 (b)(2).

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26 CFR 1.117-1: Exclusion of amounts received as a scholarship or fellowship grant.

Guidelines providing rules to be used in determining whether educational grants qualify as scholarships or fellowship grants. See Rev. Proc. 76-47, page 670.

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26 CFR 1.117-4: Items not considered as scholarships or fellowship grants. (Also Section 61; 1.61-2.)

Scholarships and fellowships; resident doctors in Family Practice Residency Program. Stipends paid by a university to a resident doctor who, while participating in a Federally funded three-year Family Practice Residency Program performs services in the university's teaching hospital and in a Model Family Practice Unit are not excludable from gross income as a scholarship or a fellowship grant.

Rev. Rul. 76-252

Advice has been requested whether, under the circumstances described below, stipends paid to resident doctors under a Family Practice Residency Program are excludable from gross income under the provisions of section 117(a) of the Internal Revenue Code of 1954.

The primary objective of the three-year Family Practice Residency Program is to produce family physicians qualified to deliver continuing comprehensive care to individuals, families, and communities, and to qualify medical school graduates as specialists in Family Practice Medicine. Participants are encouraged to practice in communities that are disadvantaged and medically understaffed.

The program differs from other residency programs in that the residents, instead of being assigned to a specific area of specialization within the hospital, rotate among the various departments within the hospital that serves as the teaching hospital for a university. For example, during the first two years of the program residents rotate between Internal Medicine, Pediatrics, Psychiatry, Surgery, Outpatient, Emergency Room and other departments in the hospital. Also, during the first two years the residents spend two afternoons each week in a Model Family Practice Unit and attend meetings of the Academy of Family Practice and the American Public Health Association. The residents spend their third year primarily in Model Family Practice Units with up to one third of their time available for electives in medical specialities. In addition, residents may serve as replacements for medical practitioners who want to have their practices covered when they are ill, on vacation, or are attending educational conferences.

While rotating through the various hospital departments, the responsibilities of the residents depend on their capabilities and functional competence, and the function of the departments. Generally, while working under the supervision of a senior staff attending physician, they participate in night call schedules, serve as admitting physicians in rotation with other residents, surpervise medical students, attend conferences and scheduled education activities, assume responsibility for the care of ambulatory patients, refer patients to specialized care, and see and treat patients in the in-patient, out-patient, and consulting services.

Each Model Family Practice Unit consists of a full-time staff of doctors and family health teams and serves as an ambulatory, primary care facility for a designated geographic area. Residents serving in a unit are assigned patients based on the skill and competency of each resident. The residents have total management responsibility for their patients and no other physician is allowed to care for those patients except in emergencies. House calls are made at the discretion of the residents.

The program is funded by a grant from the United States Department of Health, Education, and Welfare to the medical university and stipends are paid to the residents by the university. The amount of the stipend increases each year the residents continue in the program. The program is under the direction of the dean of the university's school of medicine, and the work of each resident is supervised by participating faculty members, practitioners, and heads of various specialist services within the hospital and Model Family Practice Unit. Residents are not degree candidates

but are attempting to qualify for the National Boards in Family Practice.

Section 61 of the Code and the income tax regulations thereunder provide that, except as otherwise provided by law, gross income means all income from whatever source derived including, but not limited to, compensation for services.

Subject to certain limitations and qualifications, section 117(a) of the Code provides that gross income of an individual does not include any amount received as a scholarship at an educational institution or as a fellowship grant.

Whether an amount received by an individual is excludable from gross income under section 117 of the Code depends upon the facts and circumstances under which the payment is made. The exclusion provision applies only to scholarship or fellowship grants. A scholarship or fellowship grant, as defined in section 1.117-3 of the Income Tax Regulations, is an amount paid to or for the benefit of an individual to aid in the pursuit of studies or research.

However, section 1.117-4(c) of the regulations provides that any amount or amounts paid or allowed to, or on behalf of, an individual to enable the individual to pursue studies or research shall not be considered to be an amount received as a scholarship or fellowship grant if such amount represents compensation for past, present, or future employment services, or payment for services that are subject to the direction or supervision of the grantor, or if such studies or research are primarily for the benefit of the grantor. Any of these conditions will preclude a payment from qualifying as a scholarship or fellowship as defined in these regulations.

The Supreme Court of the United States in the case of *Bingler v. Johnson*, 394 U.S. 741 (1969), 1969-2 C.B. 17, upheld the validity of the regulations under section 117 of the Code as comporting with the ordinary understanding of scholarships and fellowships as relatively disinterested, "no-strings" educational grants, with no requirement of any substantial *quid pro quo* from the recipients.

Rev. Rul. 57-386, 1957-2 C.B. 107, holds that stipends received by interns and resident physicians performing services at a medical training hospital, in order to complete or receive specialized training, are compensation for services rendered and are includible in the gross incomes of the recipients. The basis for the holding in Rev. Rul. 57-386 is that although the interns and residents acquired training and experience in their particular specialties they were primarily performing services for the hospital as physicians.

Although the residents in the instant case acquire training and experience while participating in the Family Practice Residency Program, they are primarily performing services as resident doctors whether assigned to the hospital or to a Model Family Practice Unit.

Accordingly, the stipends paid to the resident doctors for participating in the Family Practice Residency Program are not excludable from gross income as scholarships or fellowship grants under section 117(a) of the Code, but are includible in income under section 61.

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26 CFR 1.117-4: Items not considered as scholarships or fellowship grants.
(Also Section 61; 1.61-1.)

Educational expenses; employee; tuition fees paid by employer. Tuition fees paid by an employer on behalf of employees who have at least three months continuous service, enroll in courses that are not required to be job related or leading to a degree, are not committed to continue as employees either during the course of study or for any length of time after the tuition is paid, and are required to produce grade "C" or better to be eligible for further aid, are not excludable from the employees' gross income as scholarships or fellowship grants. However, the educational expenses may be deductible if they meet the requirements of section 1.162-5 of the regulations. Rev. Ruls. 76-62, 76-65, and 76-71 distinguished.

Rev. Rul. 76-352

Advice has been requested whether, under the circumstances described below, amounts paid by an employer on behalf of its employees under a tuition payment plan are excludable from the gross incomes of recipients as scholarships or fellowship grants under section 117 of the Internal Revenue Code of 1954.

The employer instituted a plan whereby it pays the tuition of employees to aid them in pursuing their studies. In order to participate in the plan, the employee must have been employed by the employer for at least three months of continuous service. Under the plan, the employees may or may not be degree candidates and are eligible to enroll in any educational course whether or not it is job related. The corporation pays 75 percent of the tuition cost limited to a maximum payment each semester. Applicants must apply prior to commencement of study, and all tuition payments are made directly to the educational institution by the employer at the beginning of the semester. Participants are not committed to continue as employees either during the course of study or for any length of time after the tuition payment is made. However, participants who complete one semester of educational studies under the plan must, in order to be eligible for further aid, produce evidence of a grade of "C" or better for those studies already completed. In addition, if the employee leaves the employment, the employer pays the tuition to the end of the semester but does not continue to pay tuition thereafter.

Section 61 of the Code provides that, unless otherwise excluded by law,

gross income means all income from whatever source derived including, but not limited to, compensation for services.

Section 117(a) of the Code provides, subject to certain limitations and qualifications, that gross income of an individual does not include amounts received as a scholarship at an educational institution or as a fellowship grant.

Section 117(b)(2) of the Code provides, however, that if the recipient is not a degree candidate, amounts received as a scholarship or fellowship grant are excludable only if the grantor fits within one of four categories specified in paragraph (b)(2)(A) of section 117. The employer granting the funds in this case fits none of the specified categories. Thus its grants on behalf of employees who are not degree candidates are not excludable from their gross incomes under section 117.

Moreover, whether an amount received by an employee, who is or is not a degree candidate, is excludable from the employee's gross income under section 117 of the Code depends upon the facts and circumstances under which the payment is made. Section 117 applies only to scholarship or fellowship grants.

A scholarship or fellowship grant is defined in section 1.117-3 of the Income Tax Regulations as an amount paid to or for the benefit of an individual to aid in the pursuit of studies or research. Section 1.117-4(c) of the regulations provides, however, that any amount or amounts paid or allowed to, or on behalf of, an individual to enable the individual to pursue studies or research shall not be considered to be an amount received as a scholarship or fellowship grant if such amount represents either compensation for past, present, or future employment services, or payment for services that are subject to the direction or supervision of the grantor, or if the studies or research are primarily for the benefit of the grantor. Any of these conditions will preclude a payment from qualifying as a scholarship or fellowship grant as defined in these regulations.

In the instant case, the tuition benefits are made available by the employer to all its employees (with three months continuous service) for educational purposes as part of the pattern of employment and serve either as compensation for past or present services, or as an inducement for future services. Accordingly, the tuition payments are not excludable under section 117 of the Code as scholarships or fellowship grants.

In Rev. Rul. 76-71, 1976-1 C.B. 308, an employer pays tuition costs of outside educational courses taken by its employees *if such courses are job related*. These amounts are noncompensatory business expenses of the employer and therefore subject to the reporting requirements of section 1.162-17(b)(1) of the regulations if reimbursed to the employee. If paid directly to the educational institution, the amounts are not income to the employees.

In the present case, however, the employer's tuition payment plan is not limited to job related courses. The employee is free to choose any course he desires. Therefore, in the present case, the employer's tuition payments are compensatory and are includible in the employee's gross incomes under section 61 of the Code as additional compensation. The provisions of section 1.162-17(b)(1) of the regulations are not applicable.

However, the expenses may be deductible as educational expenses by the employees under section 1.162-5 of the regulations if they meet all the requirements of that section.

Rev. Rul. 76-71 is distinguished. Rev. Rul. 76-62, 1976-1 C.B. 12 and Rev. Rul. 76-65, 1976-1 C.B. 46 are also distinguished.

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26 CFR 1.117-4: Items not considered as scholarship or fellowship grants.

Scholarships; Armed Force Health Professions Scholarshi Program. Amounts received for pa ticipation during the calend years 1976 through 1979, by thos who were participants in 1976, i the Armed Forces Health Profes sions Scholarship Program for edu cational expenses incurred are e cludable from gross income a scholarships; Rev. Rul. 76-99 am plified.

Rev. Rul. 76-517

Rev. Rul. 76-99, 1976-1 C.B. 4 holds that payments received for edu cational expenses incurred under th Armed Forces Health Professior Scholarship Program (AFHPSP), du ing the years 1973 through 1975, a excludable from gross income unde section 117 of the Internal Revenu Code of 1954. This holding is base on Pub. L. No. 93-483, 1974-2 C.I 447, which provides that any amour received from appropriated funds a a scholarship, including the value o contributed services and accommoda tions, by a member of a uniforme service who is receiving training unde the AFHPSP (or any other prograr determined by the Secretary of th Treasury or the Secretary's delegate t have substantially similar objectives shall be treated as a scholarship und section 117, whether that member receiving training while on active du or in an off-duty or inactive statu and without regard to whether a perio of active duty is required of the men ber as a condition of receiving tho payments.

The Tax Reform Act of 1976, Pu L. No. 94-455, 94th Cong. 2d Se (October 4, 1976), amended Pub. No. 93-483 and made it applicable amounts received during calendar yea 1976 through 1979, by a member of uniformed service receiving trainii under the AFHPSP during calend year 1976.

Accordingly, amounts received f the calendar years 1976 through 197

for educational expenses incurred under the AFHPSP by members of a uniformed service receiving training thereunder during calendar year 1976, are treated as if they are part of a scholarship under section 117 of the Code and are excludable from the gross income of the recipient.

Rev. Rul. 76-99 is amplified.

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26 CFR 1.117-4: Items not considered as scholarship or fellowship grants. (Also Section 61; 1.61-2.)

Scholarship program for military personnel. Payments received by military personnel as participants in the Medical, Dental, and Veterinary Education Program for Air Force Officers for educational expenses are excludable from gross income as scholarships for years 1973 through 1975, and similarly, for years 1976 through 1979, by those participating in the programs in 1976; however; regular pay and allowances received while on active duty are includible in gross income under section 61 of the Code.

Rev. Rul. 76-518

The Medical, Dental and Veterinary Education Program for Air Force Officers (MEFRO) was established by the Air Force. Under the MEFRO program, Air Force officers may obtain a degree in medicine, osteopathy, dentistry, or veterinary medicine under Air Force sponsorship. Any active or inactive military member who is a regular or reserve officer in grade captain or below, a potential Air Force ROTC graduate, or a reserve or active duty enlisted person may apply for sponsorship at an accredited school for the time normally required to earn a Doctor of Medicine, Doctor of Osteopathy, Doctor of Dental Surgery, Doctor of Dental Medicine, or Doctor of Veterinary Medicine degree from the school. The program participants have active duty status while attending school and, in addition, have promotion eligibility and are entitled to the pay and allowances of their grade. The program provides for the payment of all tuition, fees, and associated educational expenses.

A participant incurs an active duty service commitment equal to three times the length of study and, upon receipt of a degree, must accept appointment or reappointment to the Air Force.

Held, the objectives of the MEFRO are substantially similar to those of the Armed Forces Health Professions Scholarship Program (AFHPSP) within the meaning of Pub. L. No. 93-483, 1974-2 C.B. 447, as amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, 94th Cong., 2d Sess. (October 4, 1976). Rev. Rul. 76-99, 1976-1 C.B. 40, as amplified by Rev. Rul. 76-517, page 38, this Bulletin, holds that certain payments for educational expenses received by participants in the AFHPSP during the calendar years 1973 through 1979 are treated as if they are part of a scholarship under section 117 of the Internal Revenue Code of 1954, but regular pay and allowances are includible in gross income of participants under section 61. Therefore, amounts received by participants in the MEFRO, during the calendar years 1973 through 1975, from appropriated funds for tuition, fees, and associated educational expenses are excludable from their gross incomes under section 117. Similarly, such amounts received during calendar years 1976 through 1979 by individuals receiving training under MEFRO during calendar year 1976 are excludable from their gross incomes under section 117. However, regular pay and allowances received by participants in the MEFRO are includible in their gross incomes, under section 61.

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26 CFR 1.117-4: Items not considered as scholarship or fellowship grants. (Also Section 61; 1.61-2.)

Scholarship program for military personnel. Payments received by military personnel as participants in the Navy Medical and Osteopathic Scholarship Program for educational expenses are excludable from gross income as scholarships for years 1973 through 1975, and similarly, for years 1976 through 1979, by those participating in the programs in 1976; however; regular pay and allowances received while on active duty are includible in gross income under section 61 of the Code.

Rev. Rul. 76-519

The Navy Medical and Osteopathic Scholarship Program (MOSP) established by the Bureau of Naval Personnel Instruction 1520.104B provides that all Naval officers on active duty, Navy ROTC and Naval Academy midshipmen, active duty enlisted personnel, inactive Naval Reserve personnel and Marine Corps personnel are eligible, with certain exceptions, to apply for Navy sponsorship as students in medical and osteopathic schools. The participants in this program are required to accept appointments as ensigns in the Naval Reserve or in the Regular Navy assigned to active duty at a medical or osteopathic school and an active-duty service commitment is incurred by them. The MOSP participants are in an active duty status while attending school, receive full pay and allowances, and are entitled to an annual allowance not to exceed $200 to help defray expenses for books and other fees.

Held, the objectives of the MOSP are substantially similar to those of the Armed Forces Health Professions Scholarship Program (AFHPSP) within the meaning of Pub. L. No. 93-483, 1974-2 C.B. 447, as amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, 94th Cong., 2d Sess. Rev. Rul. 76-99, 1976-1, C.B. 40, as amplified by Rev. Rul. 76-517, page 38, this Bulletin, holds that certain payments for educational expenses received by participants in the AFHPSP during the calendar years 1973 through 1979

are treated as if they are part of a scholarship under section 117 of the Internal Revenue Code of 1954, but regular pay and allowances are includible in gross income of participants under section 61. Therefore, amounts received by participants in the MOSP, during the calendar years 1973 through 1975, from appropriated funds for tuition, fees, and associated educational expenses, are excludable from their gross incomes under section 117. Similarly, such amounts received during calendar years 1976 through 1979 by individuals receiving training under MOSP during calendar year 1976 are excludable from their gross incomes under section 117. However, regular pay and allowances received by participants in the MOSP are includable in their gross incomes under section 61.

Part IV.—Standard Deduction for Individuals

Section 143.—Determination of Marital Status

26 CFR 1.143-1: Determination of marital status.
(Also Section 6013; 1.6013-4.)

Marital status; effect of annulment or divorce. Taxpayers, who were married during a taxable year and filed a joint return for that year, and whose marriage was annulled in the year following their marriage were single individuals at the close of their taxable year and must file amended returns. Other taxpayers, who had been married for 10 years, who determined that for income tax purposes it would be advantageous for them to be unmarried at the close of their taxable year, obtained a divorce in a foreign jurisdiction at the end of that year, and intended to and did remarry each other in the first month of the following year were married at the close of their taxable year for purposes of sections 143 and 6013 of the Code.

Rev. Rul. 76-255[1]

Advice has been requested concerning the marital status of certain taxpayers for Federal income tax purposes under the circumstances described below.

Situation 1

A and *B* were married in 1975 and filed a joint 1975 Federal income tax return on April 15, 1976, which included their combined incomes. On April 16, 1976, a state court of competent jurisdiction annulled the marriage and decreed that no valid marriage ever existed.

Situation 2

C and *D* were married in 1964 and filed joint Federal income tax returns for the years 1964 through 1974. In 1975, *C* and *D* determined that for Federal income tax purposes it would be advantageous for them to be unmarried so that each of them could file a separate Federal income tax return as an unmarried individual.

On December 30, 1975, *C* and *D* secured a divorce under the laws of a foreign jurisdiction. For purposes of this ruling, it is assumed that such divorce was valid. However, at the time of the divorce, they intended to remarry each other and did so in January 1976.

Section 143(a)(1) of the Internal Revenue Code of 1954 provides generally that the determination of whether an individual is married shall be made as of the close of the taxable year.

Section 6013 of the Code permits a husband and wife to file a joint income tax return.

Section 1.143-1(a) and section 1.6013-4(a) of the Income Tax Regulations provide that status as husband and wife under these sections is determined as of the close of the year for two individuals having the same taxable year. These sections also provide that an individual shall be considered as married even though living apar from the individual's spouse unles legally separated under a decree of di vorce or separate maintenance.

Rev. Rul. 67-442, 1967-2 C.B. 65 provides that the Internal Revenu Service generally will not question fo Federal income tax purposes the valid ity of any divorce decree until a cour of competent jurisdiction declares th divorce to be invalid.

In *Situation 1*, a state court having competent jurisdiction has annulled the marriage and, in accordance with state law, has decreed that no valid marriage ever existed.

Accordingly, since no valid marriage ever existed *A* and *B* were single individuals as of the close of the taxable year 1975. Thus, they must file amended Federal income tax returns for 1975 as unmarried individuals.

In *Situation 2*, although *C* and *D* were divorced under the laws of the foreign jurisdiction, the divorce was not intended by them to have effect except to enable them to qualify as unmarried individuals who would be eligible to file separate returns. In addition, *C* and *D* intended to and did remarry each other early in the succeeding taxable year.

The true nature of a transaction must be considered in light of the plain intent and purpose of the statute. Such transaction should not be given any effect for Federal income tax purposes if it merely serves the purpose of tax avoidance. In determining whether it serves the purpose of tax avoidance all of the surrounding facts and circumstances are to be considered. Neither section 143 nor section 6013 of the Code or the applicable regulations thereunder contemplates a "sham transaction" designed to manipulate for Federal income tax purposes an individual's marital status as of the close of a taxable year. See *Gregory v. Helvering*, 293 U.S. 465 (1935), XIV-2 C.B. 193 (1935).

Accordingly, *C* and *D* for purposes of sections 143 and 6013 of the Code

[1] Also released as News Release IR-1632, dated July 1, 1976.

were married individuals as of the close of the taxable year 1975. Therefore, for 1975 they must file either a joint Federal income tax return or separate returns using rules for married individuals filing separate returns.

Part V.—Deductions For Personal Exemptions

Section 152.—Dependent Defined

26 CFR 1.152-4: Support test in case of child of divorced or separated parents.

Whether a divorced taxpayer is entitled to deductions for medical expenses of the taxpayer's dependent children where the medical expenses were paid by the taxpayer's former spouse out of money provided by the taxpayer for the support of the children. See Rev. Rul. 76-344, page 82.

Part VI.—Itemized Deductions for Individuals and Corporations

Section 162.—Trade or Business Expenses

26 CFR 1.162-1: Business expenses.

Liability insurance; corporate executives; wrongful acts. The cost of liability insurance arranged by a corporation and paid by its principal executives, who were not officers or directors, to protect the executives against liability for wrongful acts while acting as corporate employees is deductible as a business expense provided deductions are itemized.

Rev. Rul. 76-277

Advice has been requested whether, under the circumstances described below, the cost of liability insurance paid by a principal executive is deductible for Federal income tax purposes pursuant to section 162(a) of the Internal Revenue Code of 1954.

A corporation does not indemnify its principal executives who are not directors or officers in the defense of lawsuits brought against them where they are found to have acted in good faith for a purpose believed to be in the interest of the corporation. However, pursuant to a resolution, the corporation arranged for such principal executives to be covered by liability insurance that protects the principal executives against liability for their "wrongful acts" defined as any alleged error or misstatement or misleading statement or wrongful act or omission or neglect or breach of duty while acting in their respective capacities as principal executives. The liability coverage under the policy is limited solely to business acts. Though the corporation initially pays the premium for such insurance, each principal executive must reimburse the corporation for the principal executive's pro rata share of the total premium.

Section 162(a) of the Code provides, in part, that there will be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-1(a) of the Income Tax Regulations provides, in part, that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. Among the items included in business expenses are insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business.

Rev. Rul. 57-502, 1957-2 C.B. 118, states that a corporate resolution requiring the assumption of certain expenses by a corporate officer would tend to indicate that those expenses are a necessary expense of that office.

Rev. Rul. 60-365, 1960-2 C.B. 49, holds that malpractice insurance premiums paid by a physician who was an employee of a hospital to protect the physician from suits for malpractice were ordinary and necessary expenses in the profession in which the taxpayer was engaged and therefore, deductible under section 162(a) of the Code.

In the instant case, the expenses were incurred in connection with the business of the principal executives as employees. They were made to protect the principal executives from liability arising from wrongful acts committed within the employees' scope of employment.

Accordingly, expenses incurred by a principal executive for payment of premiums on an insurance policy to protect the principal executive against personal liability for wrongful acts performed while acting within the principal executive's scope of employment are deductible as ordinary and necessary business expenses pursuant to section 162(a) of the Code. However, since the cost of such premiums is not among the expenses of employees that may be deducted from gross income in computing adjusted gross income under section 62, such costs are deductible by the principal executive only from adjusted gross income in computing taxable income, as defined in section 63, provided the principal executive itemizes deductions in computing individual tax liability for Federal income tax purposes.

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26 CFR 1.162-1: Business expenses. (Also Section 61; 1.61-2.)

Business expense; faculty member's payment for substitute. A faculty member who is granted a sabbatical leave at full salary and, as conditions of being granted the leave and of continued employment, must pay a fixed nonrefundable percentage of such salary into a fund used to compensate substitute faculty members during the leave period must include the full salary in gross income and may deduct amounts paid into the fund.

Rev. Rul. 76-286

The taxpayer is a faculty member at a school that has a sabbatical leave program whereby a faculty member can be granted a special leave of absence during which period the faculty member continues to draw full salary. As a condition to being granted such

leave and as a condition to continued employment by the school, the faculty member must pay a fixed percentage of that salary during the leave period into a special fund maintained by the school. The school uses the fund to compensate other faculty members who substitute for the faculty member on leave. The salary levels for the faculty member on leave and the substitute may differ so that the amount the faculty member on leave must pay into the fund may be more or less than the amount the substitute receives from the fund as compensation. No amount paid into the fund is refundable. The taxpayer participated in the sabbatical leave program for four months during the taxable year.

Held, the faculty member must include in gross income under section 61 of the Internal Revenue Code of 1954 the full amount of the salary including the full amount that was paid during the sabbatical leave.

Held further, the payment of the fixed percentage amount to the fund, required under the school's sabbatical leave program, is deductible from the faculty member's adjusted gross income as an ordinary and necessary trade or business expense under section 162 of the Code, provided the taxpayer itemizes the deductions.

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26 CFR 1.162-1: Business expenses. (Also Sections 167, 263, 332, 334; 1.167 (a)-3, 1.263(a)-2, 1.332-1, 1.334-1.)

Subscription liability assumed by transferee. Costs incurred by a publishing corporation in fulfilling prepaid subscription contracts entered into by its former subsidiary, prior to acquisition and liquidation by the publishing corporation, must be capitalized and added to the basis of the assets acquired in the liquidation rather than currently deducted. Costs incurred in publishing copies of the same periodicals for sale at news stands, however, are currently deductible.

Rev. Rul. 76-520

Advice has been requested whether, under the circumstances described below, the taxpayer may properly deduct, under section 162 of the Internal Revenue Code of 1954, the costs incurred in fulfilling the obligation of its former subsidiary to deliver certain periodicals.

In June 1975, a publishing corporation, *P*, purchased all the stock of *S*, another publishing corporation, for 5,000*x* dollars. In July 1975, *P* caused *S* to be liquidated under section 332 of the Code, with the basis of the assets acquired from *S* determined under section 334(b)(2). The trade name and subscription lists were among the assets acquired by *P* from *S*.

P also assumed the obligation of *S* to fulfill the existing subscription contracts with *S*'s prepaid subscribers, which *S* had entered into prior to the stock acquisition. *S* had included in its gross income the prepaid subscriptions in its final taxable year. After the liquidation, *P* incurred costs of 500*x* dollars for preparation and delivery of the periodicals attributable to such prepaid subscribers. In addition to the periodicals distributed to these subscribers, *P* also published copies for sale on the news stand at a cost of 600*x* dollars.

The specific question presented is whether *P* may deduct, as an ordinary and necessary business expense under section 162 of the Code, the costs incurred in fulfilling the obligation assumed for later delivery of the periodicals under the prepaid subscription agreements contracted by *S* with its subscribers prior to the acquisition of its stock by *P*.

Section 162 of the Code provides, in general, that there shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during a taxable year in carrying on any trade or business.

Section 263 of the Code provides, in general, that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of property.

Under section 334(b)(2) of the Code, the basis of property in the hands of the distributee (*P*) is the adjusted basis of the stock with respect to which the distribution was made with adjustments to the adjusted basis as prescribed by the Income Tax Regulations thereunder. Section 1.334-1(c)(4)(v)(a)(1) of the regulations provides, in part, that the adjusted basis of the stock of a subsidiary (*S*) will be increased by the amount of any unsecured liabilities assumed by the parent (*P*).

Section 1.334-1(c)(4)(viii) of the regulations provides, in part, that the amount of the adjusted basis of stock shall be allocated as basis among the various assets received (except cash and its equivalent) both tangible and intangible (whether or not depreciable or amortizable), and that ordinarily such allocation shall be made in proportion to the net fair market values of such assets on the date received.

Costs incurred by the acquiring corporation in satisfaction of a liability of the acquired corporation assumed by the acquiring corporation as part of the acquisition costs must be capitalized and added to the basis of the acquired assets rather than currently deducted. *See Magruder* v. *Supplee,* 316 U.S. 394 (1941), 1942-1 C.B. 173, and *Haden Co.* v. *Commissioner,* 165 F.2d 588 (5th Cir. 1948). This principle underlies the requirement of section 334(b)(2) of the Code that the basis of the stock and, in turn, the basis of the assets, be adjusted to reflect the assumption of liabilities by the acquiring corporation. *See Pacific Transport Co.* v. *Commissioner,* 483 F.2d 209 (9th Cir. 1973), *cert. denied,* 415 U.S. 948 (1974), which held that a payment made by a parent corporation in discharge of a contested liability, first asserted against a subsidiary and assumed by the parent upon liquidation of the subsidiary under section

332 and 334(b)(2), was not currently deductible by the parent; but rather, the payment must be capitalized and added to the parent's basis in the asset acquired from the subsidiary.

In the instant case, inasmuch as *P* has assumed, as part of the acquisition costs, the liability of *S* with respect to the prepaid subscription contracts, the foregoing principles are applicable.

Accordingly, the 500*x* dollar costs incurred by *P* to prepare and deliver the periodicals in fulfillment of the prepaid subscription contracts entered into by *S* prior to the acquisition of *S* stock by *P* are not currently deductible by *P* but must be added to *P*'s basis in the assets acquired from *S*. The costs of 600*x* dollars incurred by *P* to prepare periodicals sold at the news stands are deductible during the current taxable year.

Whether *P* will be entitled to a depreciation deduction with respect to the assets represented by the subscription contracts under section 167 of the Code depends upon whether *P* can establish, in accordance with Rev. Rul. 74-456, 1974-2 C.B. 65, that they are assets that have an ascertainable value separate and distinct from goodwill, and a limited useful life, the duration of which can be ascertained with reasonable accuracy.

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26 CFR 1.162-1: Business expenses.

Whether the Service will issue advance rulings that certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes when the property is "limited use property." See Rev. Proc. 76-30, page 647.

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26 CFR 1.162-1: Business expenses.

Treatment of expenses paid or incurred in a trade of business with respect to a three-family dwelling one unit of which the taxpayer occupies, one unit of which is rented to a non-relative at fair rental value, and one unit of which is rented to the taxpayer's relative for less than fair rental value. See Rev. Rul. 76-287, page 80.

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26 CFR 1.162-1: Business expenses.

Treatment of daily transportation expenses incurred between an individual's residence and place of work. See Rev. Rul. 76-453, page 86.

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26 CFR 1.162-2: Traveling expenses.

Whether amounts from a trust used to pay a Member of Congress' traveling expenses are deductible by the Member as ordinary and necessary business expenses. See Rev. Rul. 76-276, page 14.

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26 CFR 1.162-11: Rentals.

Proper time for accrual of lessee's additional rent liability for the lessor's real estate taxes. See Rev. Rul. 76-474, page 135.

Section 163.—Interest

26 CFR 1.163-1: Interest deduction in general.

Treatment of the deduction for interest paid or incurred with respect to a three-family dwelling one unit of which is rented for less than fair rental value to the taxpayer's relative. See Rev. Rul. 76-287, page 80.

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26 CFR 1.163-1: Interest deduction in general.

Whether the removal of the "hardship" requirement for an early redemption of a certificate of deposit (CD) affects the accrual of interest on the CD under the facts set forth in Rev. Rul. 71-63. See Rev. Rul. 76-308, page 133.

Section 164.—Taxes

26 CFR 1.164-1: Deduction for taxes.

Real property taxes; annual assessments paid to homeowners association. Annual assessments paid to a homeowners association by its members for the exclusive purpose of promoting the recreation, health, safety, and welfare of the residents and for maintaining common areas of a residential housing project are not deductible as real property taxes under section 164(a) of the Code.

Rev. Rul. 76-495

Advice has been requested whether annual assessments paid to a homeowners association by its members are deductible as real property taxes under section 164(a) of the Internal Revenue Code of 1954.

The homeowners association is a corporation organized to maintain and care for the common property of a residential housing project. Each person who owns a lot within the confines of the housing project is a member of the association. Membership is appurtenant to and may not be separated from ownership of a lot, and ownership of a lot is the sole qualification for membership in the association. The association imposes an annual assessment on the owner of each lot to be used exclusively to promote the recreation, health, safety, and welfare of the residents of the project and to maintain the common areas of the project. Under the association's by-laws each member is required to pay the annual assessment. An unpaid assessment is a charge on the land and is a continuing lien on the property against which the assessment is made.

Section 164(a) of the Code allows as a deduction state and local, and foreign, real property taxes paid or accrued within the taxable year.

Section 164(b)(3) of the Code provides that a state or local tax includes only a tax imposed by a state, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

In this case, the annual assessments are imposed by the association and not by the state or political subdivision in which the housing project is located.

Accordingly, in the instant case, the annual assessments paid to the association by its members are not state or local real property taxes and, therefore, are not deductible as real property taxes under section 164(a) of the Code.

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26 CFR 1.164-1: Deduction for taxes.

Treatment of the deduction for taxes paid or incurred with respect to a three-family dwelling one unit of which is rented for less than fair rental value to the taxpayer's relative. See Rev. Rul. 76-287, page 80.

Section 165.—Losses

26 CFR 1.165-1: Losses.

Whether a business loss deduction is allowable to a Member of Congress for the repayment of unexpended contributions to contributors where the contributions were previously includible in the Member's gross income. See Rev. Rul. 76-276, page 14.

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26 CFR 1.165-1: Losses.

Whether the recipient of a taxable award, who is required to repay a portion of such award in a subsequent year, may deduct the amount of such repayment. See Rev. Rul. 76-374, page 19.

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26 CFR 1.165-1: Losses.

Whether the principle in section 165(e) of the Code that treats theft losses as sustained only in the year of discovery applies to the computation of "losses incurred" under section 832(b)(5) by a casualty insurance company that sustains losses on policies insuring against theft and embezzlement. See Rev. Rul. 76-412, page 209.

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26 CFR 1.165-8: Theft losses.

Whether the principle in section 165(e) of the Code that treats theft losses as sustained only in the year of discovery applies to the computation of "losses incurred" under section 832(b)(5) by a casualty insurance company that sustains losses on policies insuring against theft and embezzlement. See Rev. Rul. 76-412, page 209.

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26 CFR 1.165-11: Election in respect of losses attributable to a disaster.

Disaster losses; year of deduction. Disaster areas in which losses during 1976 qualify for special tax treatment under section 165(h) of the Code are listed.

Rev. Rul. 76-521

Under section 165(h) of the Internal Revenue Code of 1954, a taxpayer who suffers a disaster loss may elect to take a deduction for that loss on the Federal income tax return for the taxable year immediately preceding the taxable year in which the disaster occurred provided the loss is one that occurred in an area determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974.

The election to deduct for the preceding year must be made on or before the later of (1) the original due date of the taxpayer's income tax return for the year in which the disaster occurred, or (2) the due date of the preceding year's return (taking into account extensions of time for filing granted to the taxpayer). Section 1.165-11 of the Income Tax Regulations sets forth the procedures for making an election with respect to such losses.

Drought related losses sustained by taxpayers within the areas of certain states that have been declared by the President to be disaster areas because of the impact of drought are deductible only when such losses are incurred with respect to a trade or business or any transaction entered into for profit. See Rev. Rul. 66-303, 1966-2 C.B. 55, which holds that damage to or loss of property through progressive deterioration caused by a prolonged drought will not be considered a casualty loss under section 165(c)(3) of the Code after December 31, 1965.

The President has determined that areas in the states and territories listed below have been adversely affected by natural disasters of sufficient severity occurring during 1976 to warrant disaster assistance by the Federal Government under the Disaster Relief Act of 1974.

States or Territories Containing Disaster Areas in 1976	Type of Disaster	Date Disaster Occurred or Date of Declaration in the Case of Drought
Arkansas	Tornadoes	March 26, 1976
	Impact of drought	December 3, 1976[1]
California	Severe storms and flooding associated with Tropical Storm Kathleen	September 10, 1976
	Severe storms and flooding	September 23, 1976
Colorado	Severe storms, flash flooding, mudslides, and landslides	July 31, 1976
Georgia	Severe storms and flooding	May 28, 1976
Idaho	Collapse of the Teton Dam and resultant flooding	June 5, 1976
Illinois	Severe storms, tornadoes, and flooding	June 13, 1976
Kansas	Severe storms, flooding, high winds	July 2, 1976
Maryland	Severe storms and flooding	October 8, 1976
Michigan	Severe storms, icing, high winds, and flooding	March 2, 1976
	Tornadoes	March 20, 1976
Minnesota	Impact of drought	June 17, 1976

States or Territories Containing Disaster Areas in 1976	Type of Disaster	Date Disaster Occurred or Date of Declaration in the Case of Drought
Mississippi	Severe storms, tornadoes, and flooding	March 26, 1976
Missouri	Severe storms and flooding	July 2, 1976
	Impact of drought	September 24, 1976
Nebraska	Ice storms and high winds	March 30, 1976
New Jersey	Severe storms, high winds, and flooding associated with Hurricane Belle	August 9, 1976
	Ice Conditions on the Delaware Bay and its tributaries and along the Atlantic Coast	December 26, 1976
New York	Ice storm and subsequent severe storms and flooding	March 2, 1976
	Flash flooding	June 19, 1976
	Severe storms and flooding	July 11, 1976
	Hurricane Belle	August 9, 1976
North Dakota	Flooding	March 18, 1976
	Impact of drought	July 21, 1976
Northern Mariana Islands	Typhoon Pamela	May 20, 1976
	Typhoon Therese	July 13, 1976
Oklahoma	Severe storms and tornadoes	March 26, 1976
	Severe storms and flooding	May 30, 1976
Pennsylvania	High winds and flash flooding	June 15, 1976
	Severe storms and flooding	October 8, 1976
South Dakota	Flash flooding and mudslides	June 14, 1976
	Impact of drought	June 17, 1976
Territory of Guam	Typhoon Pamela	May 20, 1976
Texas	Severe storms and flooding	June 15, 1976
Trust Territory of the Pacific Islands	Typhoon Marie	April 7, 1976
	Typhoon Pamela	May 15, 1976
Vermont	Severe storms, high winds, and flooding	July 11, 1976
	Severe storms and flooding associated with Hurricane Belle	August 9, 1976
Virginia	Impact of drought	October 15, 1976
Wisconsin	Severe storms, icing, high winds, and flooding	March 1, 1976
	Impact of drought	June 17, 1976

[1] Not previously announced.

Section 166.—Bad Debts

26 CFR 1.166-1: Bad debts.

Bad debt reserves; computation of additions. The reasonable addition to the reserve for bad debts may be an amount lesser or greater than the amount computed under the **Black Motor** decision formula as determined in the light of facts existing at the close of the taxable year.

Rev. Rul. 76-362

Advice has been requested concerning the deduction for a reasonable addition to a reserve for bad debts under section 166 of the Internal Revenue Code of 1954, under the circumstances described below.

The specific question is whether the formula set forth in *Black Motor Company, Inc.*, 41 BTA 300 (1940), *acq.*, 1940-1 C.B. 1, *aff'd*, 125 F.2d 977 (6th Cir. 1942), for computing an addition to a bad debt reserve is the only means for determining the reasonableness of an addition to a reserve for bad debts under section 166(c) of the Code. The *Black Motor* formula uses the past ex-

perience of a taxpayer to determine a reasonable addition to the bad debt reserve.

Section 166(c) of the Code provides that in lieu of any deduction using the specific charge-off method, there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

Section 1.166-4(b)(1) of the Income Tax Regulations provides, in part, that the reasonableness of an addition to a reserve for bad debts is to be determined in the light of facts existing at the close of the taxable year of the proposed addition.

The *Black Motor* case sets forth the most widely applied formula for determining additions to bad debt reserves. It applies the taxpayer's own experience with losses in prior years and establishes a percentage level for the reserve in determining the need and amount of a current addition. As a general rule, the Commissioner of Internal Revenue will apply the *Black Motor* formula in determining what is a reasonable addition to the reserve for bad debts.

In *Westchester Development Company*, 63 T.C. 198 (1974), *acq.*, 1975-2 C.B. 2, the United States Tax Court held, in a situation where the additions to the reserve were recommended by an accounting firm, that the increase claimed by the taxpayer to its reserve for bad debts was reasonable, as such amount was determined in the light of the facts existing at the close of the taxable year of the proposed addition.

If a taxpayer considers that it is entitled to a larger addition to its reserve for bad debts than its past experience would indicate is necessary, it must substantiate the larger addition. For example, a mere aging of accounts is not by itself considered enough to overcome the Commissioner's determination as was pointed out in *Haskel Engineering & Supply Co.*, 380 F.2d 786 (9th Cir. 1967).

Accordingly, as a general rule, the *Black Motor* formula may be used to determine a reasonable addition to a reserve for bad debts under section 166(c) of the Code. However, if the taxpayer can demonstrate that an amount greater than the amount determined under the *Black Motor* formula is reasonable, in light of the facts existing at the close of the taxable year, the taxpayer may compute the greater amount to be added to the reserve for bad debts. Further, if the Commissioner finds that an amount lesser than the amount determined under the *Black Motor* formula is reasonable in light of the facts existing at the close of the taxable year, then the Commissioner may require the lesser amount to be added to the reserve for bad debts.

In any case where the Service challenges the reasonableness of the taxpayer's addition to a bad debt reserve, whatever formula may have been applied, the taxpayer bears the burden of showing that its addition is reasonable and that the proposed adjustment constitutes an abuse of discretion. *Westchester Development Company.*

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26 CFR 1.166-1: Bad debts.

Whether section 1.1502-14(d) of the regulations (dealing with stocks, bonds, and other obligations of members) operates to defer and not currently allow a deduction for an addition to a reserve for bad debts under section 166(c) of the Code computed under section 585(b)(2). See Rev. Rul. 76-430, page 183.

Section 167.—Depreciation

26 CFR 1.167(a)-1: Depreciation in general.

Whether the Service will issue advance rulings that certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes when the property is "limited use property." See Rev. Proc. 76-30, page 647.

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26 CFR 1.167(a)-1: Depreciation in general.

Treatment of the deduction for depreciation with respect to a three-family dwelling one unit of which is rented for less than fair rental value to the taxpayer's relative. See Rev. Rul. 76-287, page 80.

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26 CFR 1.167(a)-1: Depreciation in general.

Whether a disposition of property occurs when an oil rig is removed outside the taxing jurisdiction of the United States. See Rev. Rul. 76-339, page 251.

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26 CFR 1.167(a)-3: Intangibles.

Whether the taxpayer is entitled to a depreciation deduction with respect to prepaid subscription contracts acquired in the liquidation of a subsidiary corporation. See Rev. Rul. 76-520, page 42.

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26 CFR 1.167(a)-11: Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.
(Also Section 46; 1.46-3.)

Depreciation; "first placed in service"; electric generating unit. A public utility's coal-fired electric generating unit was first placed in service for investment credit and depreciation purposes on the date it was placed in the utility's control by the contractor, synchronized into the power grid, and daily operation begun, even though further testing and increasing the height of a waste disposal dam was necessary.

Rev. Rul. 76-256

Advice has been requested as to when a coal-fired electric generating unit was first placed in service for depreciation and investment credit purposes, under the circumstances described below.

The taxpayer, a regulated electric utility company that files its Federal income tax return on a calendar year basis and uses the accrual method of accounting, owns a coal-fired electric generating unit, construction of which commenced in September 1971.

The major components that are necessary to the operation of the generating unit include: main steam/hot and cold reheat steam system; main

boiler water/steam system; condensate/feedwater system; condensate make-up system; main boiler fuel system; auxiliary boiler and steam system; air quality control system; waste disposal system; main turbine system; and coal handling system.

On December 11, 1975, necessary permits and licenses to operate the coal-fired electric generating facility had been approved.

December 11, 1975, was also the date of synchronization of the generating unit into the power grid of the company and the date when the critical testing had been completed on the component systems of the coal-fired electric generating facility to assure that the generating unit could operate in its intended manner.

In addition, the generating unit was placed in the control of the taxpayer by the contractor on December 11, 1975, and daily operation of the unit began. However, subsequent testing was performed to determine and eliminate latent defects, if any.

A substantial portion of the projected cost of the waste disposal system was attributable to a 400-foot high dam that was not completed on December 11, 1975. However, on this date the dam was of sufficient height to take care of the current waste disposal though it would have to be increased as waste disposal requirements increased. The height of the dam did not interfere with the generating unit's intended purpose on December 11, 1975.

The coal-fired electric generating unit is depreciable property and has a useful life of more than 3 years.

Section 38 of the Internal Revenue Code of 1954 allows a credit against Federal income tax for qualified investment in section 38 property. The determination of what property qualifies as section 38 property is made in accordance with the rules provided in section 48.

Section 48(a)(1) of the Code provides, in pertinent part, that in order to qualify as section 38 property, the property must be depreciable and have a useful life of 3 years or more.

Section 167(a) of the Code provides, in part, that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business.

Section 1.167(a)-11(e)(1)(i) of the regulations provides, in part, that property is first placed in service when it is in a condition or state of readiness and is available for a specifically assigned function. In general, the provisions of section 1.46-3(d)(1)(ii) and (d)(2) apply for the purpose of determining the date on which property is placed in service.

Section 1.46-3(d)(1) of the regulations provides, in part, that for purposes of the investment credit allowed by section 38 of the Internal Revenue Code of 1954, property shall be considered placed in service in the earlier of the following taxable years: (i) the taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or (ii) the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function.

Section 1.46-3(d)(2) of the regulations provides, in part, that equipment acquired by a taxpayer for a specifically assigned function in his trade or business that is operational but is undergoing testing to eliminate any defects is considered in a condition or state of readiness and availability for a specifically assigned function.

Under the circumstances described above, the generating unit in the instant case was in a condition or state of readiness and availability for a specifically assigned function on December 11, 1975, in that the necessary permits and licenses had been approved, the critical tests for the various components were complete, the generating unit was placed in the control of the taxpayer by the contractor, the generating unit was synchronized into the taxpayer's power grid for its function in the business of generating electric energy for the production of income, and daily operation of the generating unit began, notwithstanding the fact that the generating unit would undergo further testing to eliminate any defects and the height of the dam would have to be increased for future requirements.

Accordingly, in the instant case, the coal-fired electric generating facility was "first placed in service" on December 11, 1975, for depreciation and investment credit purposes.

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26 CFR 1.167(a)-11: Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.
(Also Section 46; 1.46-3.)

Depreciation; "first placed in service"; nuclear electric generating unit. A nuclear electric generating unit is first placed in service for investment credit and depreciation purposes when the unit is physically and legally placed in the control of the owners by the contractor and is fully operational, even though it is still undergoing testing to eliminate any defects and to demonstrate reliability.

Rev. Rul. 76-428

Advice has been requested as to when a nuclear electric generating unit ("unit") was first placed in service for depreciation and investment credit purposes, under the circumstances described below.

The taxpayer, a regulated electric utility company that files its Federal income tax returns on a calendar year basis, owns a unit, construction of which commenced in September 1972.

The unit was constructed for the taxpayer pursuant to a contract. The major components that are necessary to the operation of the unit include: a nuclear steam supply system; a re-

actor auxiliary system; a control and safety instrumentation system; a radioactive waste disposal system; a fuel handling and storage system; a turbine system; and a containment system.

On December 23, 1975, the unit was structurally complete in all essential respects. All systems had been proven operational during the preoperational testing program. A full term, full power operating license was issued for the unit on November 19, 1975. All nuclear fuel assemblies were loaded in the reactor on November 24, 1975. Criticality of the reactor was achieved on December 16, 1975. Nuclear steam supply turbines were operational on December 18, 1975. License restriction on the main steam isolation valve was lifted on December 22, 1975. On December 23, 1975, initial synchronization and power operation were achieved at greater than 17 percent of the electrical capacity of the unit. As of December 23, 1975, all construction work was essentially complete and the only remaining contractor personnel on the site were in support of startup and maintenance activities, and the completion of insulation.

The unit was physically in the control of the owners, with all the legal attributes of ownership such as title, risk of loss, and liability. The unit was fully operational on December 23, 1975, at which time all equipment was performing its specifically assigned function, that is, operating as a unit even though equipment was still undergoing testing to eliminate any defects and to demonstrate reliability. All critical tests necessary for power operation were performed prior to December 23, 1975. There was a partial shutdown of the unit on December 24, 1975, which was due to an abundance of hydro-generated electricity rather than to any problems concerning the unit.

The taxpayer elected to apply the provisions of section 1.167(a)-11 of the Income Tax Regulations concerning the class life asset depreciation range system for eligible property placed in service in 1975 and adopted the half year convention set forth in section 1.167(a)-(11)(C)(2)(iii) for depreciation purposes. The unit is depreciable property and has a useful life of more than 3 years.

Section 38 of the Internal Revenue Code of 1954 allows a credit against Federal income tax for qualified investment in section 38 property. The determination of what property qualifies as section 38 property is made in accordance with the rules provided in section 48.

Section 48(a)(1) of the Code provides, in pertinent part, that in order to qualify as section 38 property, the property must be depreciable and have a useful life of 3 years or more.

Section 167(a) of the Code provides, in part, that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business.

Section 1.46-3(d)(1) of the regulations provides, in part, that for purposes of the investment credit allowed by section 38 of the Code, property shall be considered placed in service in the earlier of the following taxable years: (i) the taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or (ii) the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function.

Section 1.46-3(d)(2)(iii) of the regulations provides, in part, that equipment acquired by a taxpayer for a specifically assigned function in the taxpayer's trade or business that is operational but is undergoing testing to eliminate any defects is considered to be in a condition or state of readiness and availability for a specifically assigned function.

Section 1.167(a)-11(c)(2)(iii) of the regulations provides, in part, that the depreciation allowance for a vintage account for which the taxpayer adopts the "half year convention" shall be determined by treating all property in the account as placed in service on the first day of the second half of the taxable year.

Section 1.167(a)-11(e)(1)(i) of the regulations provides, in part, that property is first placed in service when it is in a condition or state of readiness and is available for a specifically assigned function. In general the provisions of section 1.46-3(d)(1)(ii) and (d)(2) apply for the purpose of determining the date on which property is placed in service.

Under the facts and circumstances described above, the nuclear generating unit in the instant case was in a condition or state of readiness and availability for a specifically assigned function on December 23, 1975, in that the necessary permits and licenses had been approved, the critical tests for the various components had been completed, the nuclear generating unit had been placed in the control of the taxpayer by the contractor, and the generating unit had been synchronized into the taxpayer's power grid for its function in the business of generating nuclear electric energy for the production of income, even though the generating unit would undergo further testing to eliminate any defects. The unit was physically in the control of the owners who possessed all the legal attributes of ownership.

Accordingly, in the instant case, the nuclear electric generating unit was "first placed in service" on December 23, 1975, for depreciation and investment credit purposes. Therefore, the taxpayer is entitled to deduct 6 months depreciation and to claim the investment credit on its 1975 Federal income tax return with respect to this unit.

Compare Rev. Rul. 76-256, page 46, this Bulletin, which concerns when a coal-fired electric generating unit was first placed in service for depreciation and investment credit purposes.

26 CFR 1.167(a)-11: Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.
(Also Section 446; 1.446-1.)

Depreciation; change to declining balance for class life assets. A taxpayer who has elected the class life asset depreciation range system is not permitted, under section 1.167(a)-11(c)(1)(iii) of the regulations, to change from the straight line method of depreciation to the declining balance method.

Rev. Rul. 76-438

A taxpayer that had elected the Class Life Asset Depreciation Range (CLADR) System under the provisions of section 1.167(a)-11 of the Income Tax Regulations for depreciable property acquired and placed in service after December 31, 1970, requested permission to change its depreciation method of accounting from the straight line method to the declining balance method, using a rate not in excess of 200 percent of the applicable straight line rate.

Under section 1.167(a)-11(c)(1)(iii) of the regulations, relating to changes in the method of depreciation for CLADR System property during the asset depreciation range period for a vintage account, the taxpayer is only permitted to change from a declining balance method of depreciation to the sum of the years-digit method of depreciation, and from a declining balance method of depreciation or the sum of the years-digits method of depreciation to the straight line method of depreciation, with respect to such account. With certain exceptions not relevant here, no other changes in method of depreciation adopted for a vintage account are permitted. The change in method applies to all property in the vintage account and must be adhered to for the entire taxable year of the change.

Held, the requested change in method of accounting does not fall within the purview of the changes in accounting methods allowable under section 1.167(a)-11(c)(1)(iii) of the regulations. Therefore, the requested change in method of accounting is not allowable.

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26 CFR 1.167(a)-11: Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.

Depreciation; class life; conventions. The restriction in section 167(m)(2) of the Code against use of a convention providing a greater depreciation allowance than would be permitted if assets were placed in a service ratably during the year does not prevent adoption of the modified half-year convention under 1.167(a)-(11)(c)(2)(ii) of the regulations.

Rev. Rul. 76-522

Advice has been requested whether, under the circumstances described below, the taxpayer may adopt the modified half-year convention for property placed in service under section 1.167(a)-11(c)(2)(ii) of the Income Tax Regulations.

The taxpayer, a regulated public utility company, files its Federal income tax returns on a calendar year basis. For depreciation purposes, the taxpayer elected the class life asset depreciation range (CLADR) system and adopted the modified half-year convention under section 1.167(a)-11 of the regulations.

The taxpayer constructed a nuclear electric generating unit over a period of years commencing in 1969 and placed the property in service on March 9, 1973.

Section 167(m)(2) of the Code provides, in part, that no convention may be used for property placed in service during a taxable year, that generally would provide greater depreciation allowances during the taxable year in which the assets are placed in service than would be permitted if all assets were placed in service ratably throughout the year and if depreciation allowances were computed without regard to any convention.

Section 1.167(a)-11(c)(2)(i) of the regulations provides for only two depreciation conventions under the CLADR system of depreciation (the half-year convention and the modified half-year convention); and the same convention must be adopted for all vintage accounts of a taxable year.

Section 1.167(a)-11(c)(2)(ii) of the regulations provides for the modified half-year convention, which allows a full year's depreciation deduction for assets placed in service during the first half of the taxable year and no depreciation deduction for the taxable year for assets placed in service during the second half of the year.

H.R. Rep. No. 92-533, 92nd Cong., 1st Sess. 33 (1971), 1972-1 C.B. 515, accompanying the Revenue Act of 1971, Pub. L. 92-178, 1972-1 C.B. 443, states, in part, that no first-year convention is to be allowed for depreciation purposes if the convention would generally allow a greater amount of depreciation for the year assets are placed in service than the depreciation that would be allowable if it was computed without regard to any convention. In applying this test to determine whether a convention is permissible, it is to be applied on the assumption that all assets were acquired ratably throughout the year. Thus, for example, a convention that for depreciation purposes treats all property placed in service during the first half of the year as placed in service at the beginning of the year and all property placed in service during the second half of the year as placed in service at the end of the year (modified half-year convention) would be permissible. Similarly, a convention that treats all property placed in service during a year as placed in service at the mid-point of the year for depreciation purposes (half-year convention) would be permissible. *S. Rep.*

No. 92-437, 92nd Cong., 1st Sess. 50 (1971), 1972-1 C.B. 587, is substantially the same as *H.R. Rep. No. 92-533*.

Therefore, the legislative history of the Act indicates that either the modified half-year convention or the half-year convention, if adopted for all property placed in service during the taxable year, would be consistent with the requirements of section 167(m)(2) of the Code.

Accordingly, for the nuclear electric generating unit placed in service on March 9, 1973, the modified half-year convention as adopted by the taxpayer in 1973, which is one of the conventions specifically provided by the regulations, is permissible in the instant case. Compare Rev. Rul. 73-202, 1973-1 C.B. 81, regarding an averaging convention used outside the CLADR system.

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26 CFR 1.167(a)-11: Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.

Asset guideline class, guideline period, depreciation range, and guideline class repair allowance percentage under the Class Life ADR System for Liquefied Natural Gas Plants. See Rev. Proc. 76-27, page 644.

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26 CFR 1.167(a)-11: Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.

Asset guideline classes, guideline periods, depreciation ranges, and guideline class repair allowance percentages under the Class Life Asset Depreciation Range (CLADR) System for assets used in the Aircraft and Air Transportation Industry. See Rev. Proc. 76-37, page 659.

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26 CFR 1.167(k)-3: Definitions.

Depreciation; rehabilitation expenditures; low-income rental housing. A partnership that complied with section 1.167(k)-3 of the regulations for the treatment of expenditures for rehabilitation of low-income rental housing, but submits a Federal Housing Administration form "Total Family Income Certification" in lieu of the notarized statement required by section 1.167(k)-3(b)(4), can not elect to compute straight-line depreciation using a 60-month useful life and no salvage value.

Rev. Rul. 76-439

Advice has been requested whether, under the circumstances described below, a partnership qualifies to compute the depreciation deduction under the straight line method using a useful life of 60 months and no salvage value in accordance with section 167(k) of the Internal Revenue Code of 1954.

A limited partnership was formed to purchase, rehabilitate, and operate an apartment complex in a low income urban area. The partnership financed the apartment complex with mortgages guaranteed by the United States Department of Housing and Urban Development, pursuant to section 221(d)(3) of the National Housing Act, as amended by Pub. L. No. 90-448, 1968-2 C.B. 734, 90th Cong., 2d Sess. (August 1, 1968.), and rehabilitated the apartments. The apartments were rented primarily to families receiving welfare payments.

Section 167(k) of the Code provides, in part, that the taxpayer may elect, in accordance with regulations prescribed by the Secretary or the Secretary's delegate, to depreciate expenditures for the rehabilitation of low-income rental housing under the straight line method using a useful life of 60 months and no salvage value.

Section 1.167(k)-3(a)(1) of the Income Tax Regulations defines the term "rehabilitation expenditures" as amounts chargeable to capital account for depreciable property with a useful life of 15 years or more, in connection with the rehabilitation of an existing building for low-income rental housing.

Section 1.167(k)-3(b)(1) of the regulations defines the term "low-income rental housing" as any dwelling unit in a building that is held for occupancy by families and individuals of low or moderate income.

Section 1.167(k)-3(b)(2) of the regulations states that occupants of a dwelling unit are considered to be families and individuals of low or moderate income only if their adjusted income does not exceed 90 percent of the income limits prescribed by the Secretary of Housing and Urban Development for occupants of projects financed with mortgages insured under section 221(d)(3) of the National Housing Act (12 U.S.C. 17151) that bear interest at the below-market interest rate prescribed in the proviso of section 221(d)(5) of such Act.

Section 1.167(k)-3(b)(3) of the regulations describes permissible methods of computing the adjusted income of a family or individual.

Section 1.167(k)-3(b)(4) of the regulations requires a taxpayer electing to compute depreciation under section 167(k) of the Code to secure an income certification from the tenant in the dwelling unit. Also, the income certification must be sworn to before an official authorized to administer oaths (such as a notary public) and must be maintained by the taxpayer as part of the taxpayer's books and records.

The partnership elected to treat the rehabilitation expenditures attributable to more than half of its apartments under section 167(k) of the Code. The expenditures so treated qualified under section 1.167(k)-3 of the regulations in all aspects except the partnership did not obtain the sworn and notarized income certifications required by section 1.167(k)-3(b)(4) but used Federal Housing Administration's Form 1705 (Rev. 6-69), "Total Family Income Certification". These forms have a certification regarding income and amount of monthly rental, a listing of each occupant of the apartment, and were signed by the head of the family occupying each "electing apartment".

The amount of income reported on these forms was within the limits prescribed by section 1.167(k)-3(b)(2). In addition to certification, Form 1705 contains a warning referring to section 1010 of Title 18 of the United States Code, which makes it a criminal offense to submit a false statement or misrepresentation to any Agency or Department of the United States as to any matter within its jurisdiction.

When promulgation of section 1.167(k)-3(b)(4) of the regulations was being considered, the Internal Revenue Service, although aware that the above certification was being used by the Federal Housing Administration, included in the regulations the requirement of an income certification sworn to before an official authorized to administer oaths before a deduction is allowable under section 167(k) of the Code.

Accordingly, since the partnership in the instant case did not comply with the requirements of section 1.167(k)-3(b)(4) of the regulations, it does not qualify to compute the depreciation deduction of the rehabilitation expenditures under the straight line method using a 60 month useful life and no salvage value in accordance with section 167(k) of the Code.

Section 170.—Charitable, Etc., Contributions and Gifts

26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction. (Also Section 1031; 1.1031(a)-1.)

Charitable contribution; bargain sale. A corporation's exchange of timberland, with the corporation reserving the timber-cutting rights, for state-owned timberland of lesser fair market value is not a bargain sale within the meaning of section 170 of the Code, and the corporation is not entitled to a charitable contribution deduction; however, the exchange qualifies for nonrecognition of gain or loss under section 1031(a).

Rev. Rul. 76-253

Advice has been requested whether, under the circumstances described below, the transfer by a corporation of certain timberland to a state in exchange for timberland owned by the state is a bargain sale of property within the meaning of section 170 of the Internal Revenue Code of 1954.

The corporation, a manufacturer of paper and paper products, owns a significant amount of timberland in the state, and interspersed among the corporation's timberland holdings are numerous small tracts of public timberland owned by the state. The corporation conveyed to the state by quitclaim deed all right, title, and interest to one of its large tracts of timberland, but reserved to itself the timber-cutting rights in the land. The state in turn conveyed to the corporation by quitclaim deed all right, title, and interest to its various timberland holdings interspersed among the remaining tracts of timberland owned by the corporation. The land acquired by the corporation in this exchange was to be held for investment.

The acreage exchanged was approximately equal, but the fair market value of the interest in the land transferred by the corporation was greater than the fair market value of the land received from the state. The purpose of the exchange was to enable the state to obtain one large, contiguous tract of land for recreational or commercial development.

Section 170 of the Code provides, subject to certain limitations, a deduction for gifts and contributions to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

Section 170(c)(1) of the Code provides, in part, that the term "charitable contribution" means a contribution or gift to or for the use of a State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

Section 170(f)(3)(A) of the Code provides that in the case of a contribution (not made by a transfer in trust) of an interest in property that consists of less than the taxpayer's entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowed as a deduction under this section if such interest had been transferred in trust. However, section 170(f)(3)(B)(ii) provides that section 170(f)(3)(A) does not apply to the contribution of an undivided portion of the taxpayer's entire interest in property.

Section 1.170A-7(b)(1)(i) of the Income Tax Regulations provides, in part, that a deduction is allowed under section 170 of the Code for the value of a charitable contribution, other than in trust, of an undivided portion of a donor's entire interest in property. An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property, must extend over the entire term of the donor's interest in such property, and must include other property into which such property is converted.

Section 1.170A-4(c)(2)(i) of the regulations provides the rules for determining the amount of a charitable contribution deduction where there is a bargain sale of property to a charitable organization.

Section 1.170A-4(c)(2)(iii) of the regulations provides that the term "bargain sale" means a transfer of property that is in part a sale or exchange of the property and in part a charitable contribution, as defined in section 170(c) of the Code, of the property.

Thus, a bargain sale of an undivided portion of a taxpayer's entire interest in property to a state, accompanied by a donative intent on the

part of the vendor gives rise to a deductible charitable contribution.

However, in the instant case, the exchange of property between the taxpayer and the state, subject to the retention by the taxpayer of the timber-cutting rights, is not a contribution of an undivided portion of the donor's entire interest in the property within the meaning of section 1.170A-7(b)(1)(i) of the regulations, because retention of the right to cut timber is a substantial right in the property transferred to the state.

Accordingly, the exchange of properties between the taxpayer and the state is not a bargain sale of property within the meaning of section 170 of the Code, and the taxpayer is not entitled to a charitable contribution deduction on the exchange of the properties. However, under the provisions of section 1031(a), no gain or loss is recognized on the exchange of the properties, since they are of a like-kind to be held for investment or productive business use. See Rev. Rul. 72-515, 1972-2 C.B. 466.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction. (Also Section 263; 1.263(a)-1.)

Charitable contributions; payment for county road improvement. The amount paid to a county on a promissory note conditioned on, and payable upon, the county hard-surfacing the roads in the vicinity of the taxpayer's property is not deductible as a charitable contribution; however, the amount paid is a capital expenditure.

Rev. Rul. 76-257

Advice has been requested concerning the deductibility under section 170 of the Internal Revenue Code of 1954 of the payment of a promissory note to a county upon the completion of the improvement of public roads in the vicinity of the taxpayer's property.

The taxpayer, an individual, owned farm land, part of which the taxpayer farmed and part of which was leased to other farmers. The county in which the land was located embarked upon a road improvement program, to be financed by county, state, and federal funds, in the vicinity of the taxpayer's property. After grading the graveled roads as a preliminary to hard-surfacing them, the county determined that it did not have sufficient funds available for the hard-surfacing. The taxpayer and other landowners in the area served by the roads pledged an amount of money to the county on the condition that the county hard-surface the roads by the following summer. The county accepted the offer, and the taxpayer then issued a promissory note to the county for the amount of the taxpayer's pledge. The note was held by a local bank and was conditioned on, and payable upon, the completion of the project. When the hard-surfacing was completed, the taxpayer paid to the county the face amount of the note.

Section 170 of the Code provides, subject to certain limitations, a deduction for gifts and contributions to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

Section 170(c)(1) of the Code provides, in part, that the term "charitable contribution" means a contribution or gift to or for the use of a state, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

The term "charitable contribution," as used in section 170 of the Code, requires a contribution or gift. A contribution or gift, for the purposes of section 170, is a voluntary transfer of money or property made by the transferor without receipt or expectation of financial or economic benefit. If the transferor receives, or can reasonably expect to receive, sufficiently substantial financial or economic benefits in excess of those that would inure to the general public, no deduction under section 170 is allowable. *United States v. Transamerica Corp.*, 392 F. 2d 522 (9th Cir. 1968); *Singer Co. v. United States*, 449 F. 2d 413 (Ct. Cl. 1971). Also see Rev. Rul. 68-607, 1968-2 C.B. 115, and Rev. Rul. 73-113, 1973-1 C.B. 65.

In the instant case, the taxpayer offered the county a sum of money if the county resurfaced the roads in the vicinity of the taxpayer's property. Since the roads were in the vicinity of the taxpayer's property, the taxpayer could reasonably expect to receive benefits substantially greater than those that would inure to the general public.

Accordingly, in the instant case, the payment made by the taxpayer to the county is not deductible as a charitable contribution under section 170 of the Code.

Further, the amount paid to the county permanently benefited the taxpayer's property and is, therefore, a capital expenditure under section 263 of the Code.

Section 170.—Charitable, etc., Contributions and Gifts

26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Charitable contributions; retained mineral or lease rights. The donation of real property to a charitable organization with the donor retaining the mineral rights, including the sole right to exploit and sell the minerals obtained, or the donor retaining a lifetime interest in payments due under a 60-year timber lease executed the previous year is not a contribution of an undivided portion of the donor's entire interest in the property and no deduction therefor is allowable under section 170 of the Code.

Rev. Rul. 76-331

Advice has been requested concern-

ing the deductibility under section 170 of the Internal Revenue Code of 1954 of donations of real property to a charitable organization under the circumstances described below.

Situation 1. A corporation transferred a tract of land to an organization described in section 170(c)(2) of the Code. However, it retained all mineral rights with respect to the property, including the sole right to exploit and sell any minerals obtained from the property.

Situation 2. An individual, aged 50 and in good health, owned timberland that the individual leased to a corporation in 1975 for a term of 60 years. In 1976, the individual transferred this land to an organization described in section 170(c)(2) of the Code, subject to the individual's receiving, during the individual's lifetime, all the payments due under the lease. Upon the individual's death, all rights under the lease will pass to the charitable organization.

Section 170 of the Code provides, subject to certain limitations, a deduction for gifts and contributions to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

Section 170(c)(2) of the Code provides, in part, that the term "charitable contribution" means a contribution or gift to or for the use of a corporation, trust, or community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.

Section 170(f)(3)(A) of the Code denies a deduction in the case of a contribution (not made by a transfer in trust) of an interest in property that consists of less than the taxpayer's entire interest in such property. However, section 170(f)(3)(B) provides that section 170(f)(3)(A) shall not apply to a contribution of an undivided portion of the taxpayer's entire interest in property.

Section 1.170A-7(b)(1)(i) of the Income Tax Regulations provides that a deduction is allowed under section 170 of the Code for the value of a charitable contribution not in trust of an undivided portion of a donor's entire interest in property. An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted.

Thus, with respect to property contributed to a charitable organization, if the only rights retained by the donor are insubstantial, then there has been compliance with section 1.170A-7(b)(1)(i) of the regulations and a deduction would be allowed under section 170 of the Code.

In *Situation 1,* the corporation retained all mineral rights to the land and had the sole right to exploit and sell the minerals. In *Situation 2,* the right to receive the remaining payments due from the corporation from the leasing of the timberland was retained by the individual. Thus, in each situation, the taxpayer retained a substantial interest or right in the property and cannot be considered as donating an undivided portion of the taxpayer's entire interest in the property.

Accordingly, in *Situation 1* and *Situation 2,* no deduction for the property is allowable to the taxpayer under section 170 of the Code. Compare Rev. Rul. 75-373, 1975-2 C.B. 77, relating to the grant of an easement under which the grantor retained all mineral rights in the land underlying the easement but agreed to drill or mine only by slant from adjacent property so that the surface of the land would not be disturbed.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Charitable contribution; valuation of easement and subsequent conveyance of land. The fair market value of an open space easement in perpetuity in a portion of a taxpayer's land, granted to a charitable organization described in section 170(c) of the Code, is the difference between the fair market value of the entire tract of land before and after the granting of the easement. The fair market value of the taxpayer's remaining interest in the land encumbered by the easement subsequently conveyed in fee to another charitable organization is the fair market value of the actual land conveyed. Rev. Rul. 73-339 clarified.

Rev. Rul. 76-376

Advice has been requested concerning the method of determining the fair market value of real property for purposes of the charitable contributions deduction under section 170 of the Internal Revenue Code of 1954.

A taxpayer who owned in fee simple $10x$ acres of real property granted an open space easement in perpetuity in $8x$ of the $10x$ acres to Y, an organization described in section 170(c) of the Code. Subsequent to the granting of the easement to Y, the taxpayer conveyed in fee the taxpayer's remaining interest in the $8x$ acres to Z, also an organization described in section 170(c).

Section 170 of the Code provides, subject to certain limitations, a deduction for contributions and gifts to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

With regard to contributions of property, section 1.170A-1(c) of the Income Tax Regulations provides generally that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e) of the Code and section 1.170A-4(a). The

fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Rev. Rul. 73-339, 1973-2 C.B. 68, states that open space easements in perpetuity may be valued separately and distinctly. However, more often than not open space easements in perpetuity are granted by deed of gift so there is usually no substantial record of market place sales to use as a meaningful or valid comparison. As a consequence, the valuation of an open space easement in perpetuity is generally made on the basis of the "before and after" approach. Thus, the difference between the fair market value of the total property before the granting of the easement and the fair market value of the property after the grant is the fair market value of the easement given up.

Rev. Rul. 73-339 provides an example in which an easement was granted in an entire tract of land. Because the easement was granted in all of the property, the term "total property" could be interpreted as referring merely to the property in which the easement was granted. However, "total property," as used in Rev. Rul. 73-339, means the entire property, not merely the property in which the easement is granted. Thus, in the instant case, the taxpayer's total property was the $10x$ acres owned by the taxpayer, that is, the $8x$ acres in which the easement was granted plus the contiguous $2x$ acres.

Accordingly, in the instant case, for purposes of the charitable contributions deduction provided by section 170 of the Code, the fair market value of the easement in perpetuity in the $8x$ acres granted to Y is the difference between the fair market value of the entire $10x$ acres before the granting of the easement and the fair market value of the $10x$ acres after the grant.

Further, the fair market value of the taxpayer's remaining interest in the $8x$ acres conveyed in fee to Z is the fair market value of the $8x$ acres encumbered by the easement granted to Y.

Rev. Rul. 73-339 is clarified.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Charitable contribution; donation of reversionary interests in trusts. Taxpayers who established similar income trusts in 1960 and 1971 for the benefit of relatives and a long-time employee of the family owned corporation whose stock formed the trust corpus, maintained their financial security and protected against a take-over by dissidents through a reversionary interest and restrictive language in the trust instrument, and donated their reversionary interest to a charitable organization after a 1975 merger of the family corporation into a widely traded, publicly owned corporation are not prevented by the provisions of section 170(f)(3)(A) of the Code, added by the Tax Reform Act of 1969, from claiming the donation as a charitable deduction.

Rev. Rul. 76-523

Advice has been requested whether, under the circumstances described below, the donation of the reversionary interests in several trusts is deductible under the provisions of section 170 of the Internal Revenue Code of 1954.

In 1960, the taxpayers established several trusts for the benefit of their relatives, who were to receive the income interests from these trusts during their lifetimes. The taxpayers retained the reversionary interests in the trusts. In 1971, the taxpayers established a similar trust for the benefit of an individual who had been a life-long friend and valued former employee.

The corpus of each of the trusts consisted of stock in a closely held family corporation. The reversionary interests were retained by the taxpayers to, (1) insure their future financial security, and (2) to prevent outsiders, who might be potential dissidents, from acquiring the stock. To accomplish this second purpose, the trust instrument prevented the trustees from alienating the stock in any manner.

In 1975 the family corporation was merged with a large publicly owned corporation actively traded on one of the major stock exchanges. Thereafter, the corpus of each of the trusts consisted of stock of this publicly owned corporation. This merger insured the taxpayers' future financial security and eliminated the need to retain the reversionary interests in the several trusts to prevent the stock in the family corporation from being acquired by outsiders. Thereupon, the taxpayers donated their reversionary interests in the several trusts to an organization described in section 170 (c) of the Code. They also removed the restriction regarding alienation of the stock.

Section 170 of the Code provides, subject to certain limitations, a deduction for gifts and contributions to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

However, section 170(f)(3)(A) of the Code denies a charitable contribution deduction for the donation of an interest in property that consists of less than the taxpayer's entire interest in the property.

Section 1.170A-7(a)(2)(i) of the Income Tax Regulations states that notwithstanding the provisions of section 170(f)(3)(A) of the Code, a deduction is allowed for the donation of a partial interest in property transferred after July 31, 1969, if such interest is the taxpayer's entire interest in the property, such as an income interest or a remainder interest. Thus, if securities are given to A for life with the remainder over to B, and B

makes a charitable contribution of the remainder interest to an organization described in section 170(c), a deduction is allowed under section 170 for the present value of *B*'s remainder interest in the securities. If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(3)(A), the deduction will not be allowed. Thus, for example, if a taxpayer desires to contribute to a charitable organization the reversionary interest in a portfolio of stocks and bonds, and the taxpayer grants a life estate in such property to a son and immediately thereafter contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the reversionary interest.

Thus, as a general rule, section 170(f)(3)(A) of the Code, as enacted by the Tax Reform Act of 1969, section 201(a), (Pub. L. 91-172) 1969-3 C.B. 10, 49, denies a charitable contribution deduction in the case of a contribution of property that consists of less than the taxpayer's entire interest in such property. However, a deduction is allowed, as an exception to section 170(f)(3)(A), if the taxpayer created the partial interest for a reason other than the avoidance of the provisions of section 170(f)(3)(A).

In the instant case, the 1960 trusts were set up long before the revision of section 170 of the Code by the enactment of the Tax Reform Act of 1969. Thus, the taxpayers' purpose in setting up these trusts could not have been the avoidance of the provisions of section 170(f)(3)(A). Further, in view of all of the above circumstances, the taxpayer's purpose in setting up the 1971 trust was not the avoidance of the provisions of section 170(f)(3)(A), but to provide financial security to an old friend and valued former employee, while insuring their future financial security and protecting their interests in the family corporation from outside incursions. Only when these concerns were no longer relevant, because of the merger of the family corporation, did the taxpayers donate their remainder interests, which were their entire interests, to a charitable organization.

Accordingly, in the instant case, the donation of the taxpayers' reversionary interests in the several trusts qualifies for a charitable contribution deduction in the manner and to the extent provided in section 170 of the Code.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Whether a charitable contribution deduction is allowable to a Member of Congress for the donation of unexpended contributions to charitable organizations where the contributions were previously includible in the Member's gross income. See Rev. Rul. 76-276, page 14.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Whether the remainder interest of a trust is deductible as a charitable contribution under section 170 of the Code where the trust instrument provides that the trust will be deemed null and void and all assets returned to the grantors, if the Service disallows a deduction for the value of the remainder interest. See Rev. Rul. 76-309, page 196.

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26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Whether amounts turned over by members of a religious order to the order are deductible. See Rev. Rul. 76-323, page 18.

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26 CFR 1.170A-4: Reduction in amount of charitable contributions of certain appreciated property.
(Also Section 306; 1.306-1.)

Charitable contributions; section 306 stock. An example illustrates that the amount allowable as a deduction for a charitable contribution of section 306 stock, made after 1969, is the fair market value of the stock reduced by the amount of gain that would not have been long-term capital gain if the stock had been sold at its fair market value at the time of the contribution.

Rev. Rul. 76-396

Advice has been requested concerning the computation of the amount of the charitable contribution where section 306 stock, as defined in section 306(c) of the Internal Revenue Code of 1954, is contributed to an organization described in section 170(c).

Section 170 of the Code provides, subject to certain limitations, a deduction for gifts and contributions to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

Section 1.170A-1(c) of the Income Tax Regulations provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) of the Code and section 1.170A-4(a).

Section 170(e)(1)(A) of the Code, which applies to contributions paid after December 31, 1969, provides, in part, that the amount of any charitable contribution of property otherwise taken into account under section 170 must be reduced by the amount of gain that would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value determined at the time of such contribution.

Section 1.170A-4(b)(1) of the regulations provides, in part, that property to which section 170(e)(1)(A) of the Code applies includes stock described in section 306(a), to the extent that, after applying such section, gain on its disposition would not have been long-term capital gain.

Section 306(a) of the Code provides, in part, that, if a shareholder disposes of section 306 stock and such disposition is not a redemption, the amount realized is treated as gain from the sale of property that is not a capital

asset to the extent of such stock's ratable share of the amount that would have been a dividend at the time of distribution if, in lieu of section 306 stock, the corporation had distributed money in an amount equal to the fair market value of the stock at the time of distribution. Any excess of the amount realized over the sum of the amount treated as gain from the sale of property that is not a capital asset plus the adjusted basis of the stock is treated as gain from the sale of such stock.

Thus, for purposes of section 170 of the Code, the amount of a contribution of section 306 stock contributed to a charitable organization is the excess of the fair market value of such stock at the time of its contribution over the amount that would be treated as gain from the sale of property that is not a capital asset had the stock been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

The following example illustrates the application of section 170(e) of the Code to a donor's contribution of section 306 stock to a charitable organization: On January 15, 1976, a taxpayer received a distribution of section 306 stock, which the taxpayer held for investment. The fair market value of the stock on January 15 was $5,000, and the taxpayer's basis in the stock was $400. On the date of distribution, the section 306 stock's ratable share of earnings and profits of the corporation exceeded $5,000. On August 1, 1976, when the fair market value of the stock was $8,000, the taxpayer contributed it to a charitable organization. For purposes of section 170, the amount of the contribution is $3,000, the fair market value of the stock on the date of contribution ($8,000) reduced by the amount of gain that would not have been long-term capital gain if the stock had been sold ($5,000).

For the treatment of a contribution of section 306 stock to a charitable organization prior to January 1, 1970, see Rev. Rul. 57-328, 1957-2 C.B. 229.

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26 CFR 1.170A-6: Charitable contributions in trust.
(Also Sections 664, 2055, 2106, 2522; 1.664-1, 20.2055-2, 20.2106-1, 25.2522(a)-1.)

Charitable deduction; charitable remainder unitrust. The transfer of property to a charitable remainder unitrust, the trustee and remainder beneficiary of which was an organization described in sections 170(c) and 2522 of the Code at the time of the transfer, will qualify for a charitable contribution and gift tax deduction even though the governing instrument of the trust limits ultimate distribution to organizations described in section 170(c) and there exists the remote possibility the charitable remainderman would not qualify under sections 170(c) and 2522 upon termination of the trust. A charitable deduction to the donor's estate will depend on qualification of the charitable remainderman under section 2055 at the date of the donor's death.

Rev. Rul. 76-307

Advice has been requested whether the transfer of property to the *X* Foundation as trustee of a charitable remainder trust described in section 664(d)(2) of the Internal Revenue Code of 1954, under the following circumstances, will entitle the donor to the applicable deductions for charitable contributions provided under the Code.

The governing instrument of the charitable remainder trust provides that the *X* Foundation, an organization described in sections 170(c), 2055(a)(2), 2106(a)(2), 2522(a), and 2522(b) of the Code, is the trustee and remainder beneficiary and the donor is the recipient for life of a unitrust amount. The instrument further provides that if the *X* Foundation is not an organization described in section 170(c) upon the termination of the trust, final distribution shall be made to one or more organizations then described in section 170(c) as the trustee shall select. The possibility that the *X* Foundation will not be an organization described in sections 170(c), 2055(a)(2), 2106(a), 2522(a), and 2522(b) upon the termination of the trust is so remote as to be negligible. The executed instrument meets all the requirements of section 664(d)(2) and the applicable Income Tax Regulations, and created a valid trust within the meaning of applicable local law.

The specific question is whether the transfer of property to the *X* Foundation as trustee under the executed governing instrument entitles the donor to the applicable deduction allowed by section 170, 2055, 2106, or 2522 of the Code.

Section 170(a) of the Code provides that there shall be allowed as a deduction any charitable contribution described in section 170(c), payment of which is made within the taxable year. Section 2055(a) provides, in part, that in determining the taxable estate of a decedent, there shall be deducted from the value of the gross estate the amount of all bequests, legacies, devises, or transfers to be used exclusively for certain religious, charitable, scientific, literary, or educational purposes. Section 2106(a)(2) provides for a similar deduction from the value of the gross estate of a decedent nonresident not a citizen of the United States. Sections 2522(a) and 2522(b) provide for a deduction from total gifts for all transfers made for certain similar purposes by a citizen or resident and a nonresident not a citizen, respectively.

Section 25.2522(c)-3(b) of the Gift Tax Regulations provides that if an estate or interest has passed to, or is vested in, charity on the date of the gift, and the estate or interest would be defeated by the performance of

some act or the happening of some event, the possibility of occurrence of which appeared on the date of the gift to be so remote as to be negligible, the deduction is allowable. A similar provision is included in section 20.2055-2 (b) of the Estate Tax Regulations.

Accordingly, since the trust in this case satisfies the requirements of a charitable remainder unitrust described in section 664(d)(2) of the Code, the transfer of property to the *X* Foundation as trustee entitles the donor to a charitable deduction under section 170(a) for the value of the remainder interest.

With respect to the Federal gift (or estate) tax, in order for a deduction to be allowable for the value of the remainder interest of a charitable remainder unitrust, the charitable organization to or for the use of which the remainder interest passes must meet the requirements of both section 2522(a) of the Code (or section 2055(a) or 2106(a)(2), whichever is applicable) and section 664(d)(2). Substantial differences exist between the charitable deduction provisions for income and gift (or estate) taxation. Therefore, in order to be certain that a gift (or estate) tax deduction will be allowed, the governing instrument must expressly limit the ultimate distribution of the transferred property to one or more organizations described in section 170(c) that also are described in section 2522 (or section 2055 or 2106, if applicable). See Section 6.02, Comment (1), and section 4.03, Comment (2) (cross references) of Rev. Rul. 72-395, 1972-2 C.B. 340.

In the instant case, however, although the governing instrument limits the alternative remainderman only to organizations described in section 170(c) of the Code, the named charitable remainderman (*X* Foundation) is a qualified charity within the meaning of sections 170(c), and 2522(a), at the time of the transfer in trust, and the possibility that the *X* Foundation will not be an organization described in sections 170(c) and 2522(a), upon the termination of the trust (and thus will not receive the trust corpus) is so remote as to be negligible. Thus, the charitable transfer is not subject to a condition or power that would deny a gift tax deduction. Section 25.2522(c)-3(b) of the Gift Tax Regulations.

Accordingly, a charitable deduction is allowable under section 2522(a) of the Code for the value of the remainder interest in the property transferred to the *X* Foundation by the donor. Whether the donor's estate will be entitled to a charitable deduction under section 2055 will depend on the facts existing at the donor's death.

The above conclusions are equally applicable under sections 2106 and 2522(b) of the Code with respect to gifts made by a nonresident not a citizen donor under like circumstances.

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26 CFR 1.170A-9: Definition of section 170(b)(1)(A) organization.
(Also Section 509; 1.509(a)-2).

Private foundation; tutoring service. An organization exempt under section 501(c)(3) of the Code that operates a tutoring service for students on a one-to-one basis in their homes, maintains a small center to test students to determine their need for individual tutoring, and employs tutors on a part-time basis is not an educational organization of the type described in section 170(b)(1)(A)(ii).

Rev. Rul. 76-384

Advice has been requested whether the organization described below is an educational organization of the type described in section 170(b)(1)(A)(ii) of the Internal Revenue Code of 1954 and, thus, not a private foundation.

The organization is organized and operated exclusively for charitable and educational purposes and is exempt from Federal income tax under section 501(c)(3) of the Code. Its primary activity consists of operating a tutoring service for students on a one-to-one basis in their homes. The organization does not have any classrooms of its own. However, incidental to its tutoring services, it operates a small testing center where students are tested to determine their need for individual tutoring. Tutors are employed and compensated by the organization on a part-time, hourly basis, with each working only several hours per week. The organization maintains a list of qualified persons from which it selects tutors for a particular assignment.

Section 509(a) of the Code provides that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) other than an organization described in section 509(a)(1), (2), (3) or (4). The organizations within the scope of section 509(a)(1) include those described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)).

Section 170(b)(1)(A)(ii) of the Code defines educational organizations as those which normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of pupils or students in attendance at the place where their educational activities are regularly carried on.

By operating in the manner described above, the organization is not an educational organization of the type described in section 170(b)(1)(A)(ii) of the Code. Accordingly, the organization is a private foundation, unless it is otherwise described in section 509(a).

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26 CFR 1.170A-9: Definition of section 170(b)(1)(A) organization.

Hospital; additional classification. A hospital described in section 170(b)(1)(A)(iii) of the Code is not prevented by section 1.170A-9(e)(1) of the regulations from qualifying as a public supported organization under section 170(b)(1)(A)(vi) if it desires that additional classification.

Rev. Rul. 76-416

Advice has been requested whether an organization described in section 170(b)(1)(A)(iii) of the Internal Revenue Code of 1954 also qualifies as an organization described in section 170(b)(1)(A)(vi) of the Code under the circumstances described below.

The organization in question is a hospital described in section 170(b)(1)(A)(iii) of the Code. It has established that it meets the public support requirements of section 170(b)(1)(A)(vi) and has specifically requested to be classified as an organization so described.

Section 1.170A-9(e)(1) of the Income Tax Regulations states that an organization is described in section 170(b)(1)(A)(vi) of the Code if it is "(i) A corporation, trust, or community chest, fund, or foundation, referred to in section 170(c)(2) (other than an organization specifically described in paragraphs (a) through (d) of this section), and (ii) A 'publicly supported' organization". Paragraphs (a) through (d) of the cited regulation include organizations described in section 170(b)(1)(A)(iii) of the Code.

The underlying question is whether the reference in section 1.170A-9(e)(1) of the regulations to paragraphs (a) through (d) is intended to prevent an organization described in section 170(b)(1)(A)(iii) of the Code from also being described in section 170(b)(1)(A)(vi) if it desires that additional classification. There is nothing in the legislative history of section 170(b)(1)(A) to suggest such an intent. Section 1.170A-9(e)(1) of the regulations should not be interpreted as precluding an organization's classification under section 170(b)(1)(A)(vi) of the Code merely because it could also be classified under section 170(b)(1)(A)(iii). Classification of an organization under subdivision (vi) may serve its legitimate needs in particular situations (such as clarifying the status of purchased employee retirement and survivor annuities in relation to section 2039(c)(3)).

Accordingly, the organization also qualifies as an organization described in section 170(b)(1)(A)(vi) of the Code.

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26 CFR 1.170A-9: Definition of section 170(b)(1)(A) organization.
(Also Section 509; 1.509(a)-1.)

Private foundations; student intern program. An organization, exempt under section 501(c)(3) of the Code, that conducts an internship program placing college and university students with cooperating government agencies for a semester is not an educational organization described in section 170(b)(1)(A)(ii) and is a private foundation unless otherwise described in section 509(a).

Rev. Rul. 76-417

Advice has been requested whether the organization described below is an educational organization of the type described in section 170(b)(1)(A)(ii) of the Internal Revenue Code of 1954 and, thus, not a private foundation by reason of section 509(a)(1).

The organization, which is exempt from Federal income tax under section 501(c)(3) of the Code as an educational organization, conducts a student intern program with cooperating government agencies. Under an arrangement with participating colleges and universities, it places students enrolled at colleges and universities with government agencies for a semester in an internship program. It provides the students with living facilities and counseling services while they are participating in the program. It also provides the colleges and universities with an evaluation of the progress of each student in meeting his or her specific goals. Although the organization, itself, does not confer academic credit upon students enrolled in the program, some of the participating colleges and universities award academic credits for the experience in connection with their regular course of instruction.

Section 509(a) of the Code provides that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) other than an organization described in sections 509(a)(1), (2), (3), or (4). The organizations within the scope of section 509(a)(1) include those described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)).

Section 1.170A-9(b)(1) of the Income Tax Regulations provides that an educational organization is described in section 170(b)(1)(A)(ii) of the Code if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

Although the experience afforded by the organization's intern program is educational in nature, the organization's primary function is not the presentation of formal instruction and its activities fail to reflect the existence of a curriculum. Therefore, the organization fails to satisfy the requirements of section 1.170A-9(b)(1) of the regulations. Accordingly, it is not an educational organization of the type described in section 170(b)(1)(A)(ii) of the Code and it is a private foundation unless it is otherwise described in section 509(a).

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26 CFR 1.170A-9: Definition of section (170(b)(1)(A) organization.
(Also Section 509; 1.509(a)-3.)

Publicly-supported organization; large contribution. A large inter vivos gift of undeveloped land from a disinterested donor to a normally publicly supported organization exempt under section 501(c)(3) of the Code, conditioned on the land's being used in perpetuity to further the exempt organization's purposes

of preserving natural resources, constitutes an unusual grant and will not adversely affect the status of the organization as a publicly supported organization under section 170(b)(1)(A)(vi).

Rev. Rul. 76-440

Advice has ben requested whether, under the circumstances set out below, a gift of undeveloped land to an organization exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 constitutes an unusual grant for purposes of determining whether the organization qualifies as a section 170(b)(1)(A)(vi) organization.

The gift in question was made by an otherwise disinterested party, and would, by reason of its size, adversely affect the status of the organization as normally being publicly supported.

Neither the donor nor any person whose relationship to the donor is described in section 4946(a)(1)(C) through (G) of the Code created the organization, previously contributed a substantial part of the organization's support or endowment, or stands in a position of authority with respect to the organization.

The gift was made inter vivos, with the only condition placed on the gift being that the land be used in perpetuity to further the purposes set out in the organization's charter. The gift is to be used in furtherance of the organization's exempt purpose, which is to preserve the natural resources of the town in which the organization is located.

During the five years of its existence, the organization has carried on an active program of public solicitation and exempt activities. It has shown a steady increase in the number of its contributors.

The organization has received a previous gift of undeveloped land which was held to be an unusual grant by the Internal Revenue Service. However, the organization's operating expenses are primarily paid for through public support within the meaning of section 1.170A-9(e) of the Income Tax Regulations.

The organization has a representative governing body as described in section 1.509(a)-3(d)(3)(i) of the regulations.

Section 1.170A-9(e)(6)(ii) of the regulations provides that for purposes of determining whether the percent-of-support test in section 1.170A-9(e)(2) or section 1.170A-9(e)(3)(i) of the regulations is satisfied, one or more contributions may be excluded from both the numerator and the denominator of the applicable percent-of-support fraction if such contributions meet the requirements of section 1.170A-9(e)(6)(iii). This exclusion is generally intended to apply to substantial contributions or bequests from disinterested parties which:

(a) are attracted by reason of the publicly supported nature of the organization; (b) are unusual or unexpected with respect to the amount thereof; and (c) would, by reason of their size, adversely affect the status of the organization as normally being publicly supported.

Section 1.170A-9(e)(6)(iii) of the regulations provides that in determining whether a particular contribution may be excluded under section 1.170 A-9(e)(6)(ii) all pertinent facts and circumstances will be taken into consideration. No single factor will necessarily be determinative. Factors similar to the factors to be considered are found in section 1.509(a)-3(c)(4).

Section 1.509(a)-3(c)(4) of the regulations lists nine factors to be considered as follows:

(1) Whether the contribution was made by any person (or persons standing in a relationship to such person which is described in section 4946(a)(1)(C) through (G) of the Code) who created the organization, previously contributed a substantial part of its support or endowment, or stood in a position of authority with respect to the organization.

(2) Whether the contribution was a bequest or an inter vivos transfer. A bequest will normally be given more favorable consideration than an inter vivos transfer.

(3) Whether the contribution was in the form of cash, readily marketable securities, or assets which further the exempt purposes of the organization.

(4) Whether the organization has carried on an actual program of public solicitation and exempt activities, and has been able to attract a significant amount of public support.

(5) Whether the organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution. In this connection, continued reliance on unusual grants to fund an organization's current operating expenses (as opposed to providing new endowment funds) may be evidence that the organization cannot reasonably be expected to attract future support from the general public.

(6) Whether the organization previously maintained its status as normally being publicly supported without the benefit of any exclusions.

(7) Whether neither the contributor nor any person standing in a relationship to such contributor which is described in section 4946(a)(1)(C) through (G) of the Code continues directly or indirectly to exercise control over the organization.

(8) Whether the organization has a representative governing body as described in section 1.509(a)-3(d)(3)(i) of the regulations.

(9) Whether material restrictions or conditions have been imposed by the transferor upon the transferee in connection with such transfer.

The gift in this case meets the general criteria of section 1.170A-9(e)(6)(ii) of the regulations. It also satisfies the facts and circumstances test under section 1.170-9(e)(6)(iii),

although not all the factors listed in section 1.509(a)-3(c)(4) are present.

Of particular importance in this case are the facts that: (1) the donor was a disinterested party; (2) the organization's operating expenses are paid for primarily through public support; (3) the gift of undeveloped land furthered the exempt purpose of the organization; and (4) this contribution is in the nature of new endowment funds because the organization is relatively new.

Accordingly, considering all the pertinent facts and circumstances, the contribution in this case qualifies as an unusual grant for purposes of determining whether the organization qualifies as a section 170(b)(1)(A)(vi) organization.

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26 CFR 1.170A-9: Definition of section 170(b)(1)(A) organization.

Home health care. An exempt organization primarily providing health services to sick persons in their own homes under the direction of their private physicians and providing only incidental patient treatment at the organization's office, which is not equipped to serve as an outpatient facility on a continuing basis, does not qualify as a hospital as defined in section 170(b)(1)(A)(iii) of the Code.

Rev. Rul. 76-452

Advice has been requested whether the nonprofit organization described below, which is exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, qualifies as a hospital within the meaning of section 170(b)(1)(A)(iii).

The organization was created to provide health services to the sick in their own homes. The services are provided under the direction of the patient's private physician, and include nursing and therapeutic services, medical social worker services, and physical and occupational therapy. While the patients occasionally come to the organization's office to receive injections as directed by their physician, this is only a small part of the organization's activities. Medical supplies such as dressings, catheters, syringes, wheelchairs, etc., are kept at the organization's office for use in rendering its services.

Section 170(b)(1)(A)(iii) of the Code describes an organization the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research, if the organization is a hospital.

Section 1.170A-9(c)(1) of the Income Tax Regulations provides that an organization is described in section 170(b)(1)(A)(iii) of the Code if (i) it is a hospital, and (ii) its principal purpose or function is the providing of medical or hospital care or medical education or research. An outpatient clinic may qualify as a "hospital" if its principal purpose or function is the providing of hospital or medical care.

While the principal purpose of this organization is to provide medical care within the meaning of section 1.170A-9(c)(1)(ii) of the regulations, it is not a hospital within the meaning of section 1.170A-9(c)(1)(i). An organization primarily providing home health care on a visiting basis is not an outpatient clinic that qualifies as a hospital within the meaning of section 170(b)(1)(A)(iii) of the Code. Compare Rev. Rul. 73-131, 1973-1 C.B. 446, in which an organization providing outpatient health care services is held to be a nonprofit hospital referred to in section 170(b)(1)(A)(iii) for purposes of exemption from the communications tax imposed by section 4251. The organization described therein maintains a center equipped with examination and treatment rooms, dental operatories, emergency rooms, conference or consultation rooms, administrative offices, and a pharmacy, but without any facilities to house or maintain patients overnight or to provide nonambulatory care. The organization in this case primarily provides home health care and only incidentally provides a place or facility for outpatient hospital or medical care.

Accordingly, the organization described above does not qualify as a hospital within the meaning of section 170(b)(1)(A)(iii) of the Code.

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26 CFR 1.170A-9: Definition of section 170(e)(1)(A) organization.
(Also Section 507; 1.507-2.)

T.D. 7440

TITLE 26.—INTERNAL REVENUE.—CHAPTER I. SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; PART 13.—TEMPORARY TREASURY REGULATIONS UNDER THE TAX REFORM ACT OF 1969

Community trusts

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

By a notice of proposed rule making appearing in the Federal Register for October 8, 1971 (36 F.R. 19598), amendments to the Income Tax Regulations (26 CFR Part 1) were proposed in order to define certain community trusts under section 170(b)(1)(A)(vi) of the Internal Revenue Code of 1954, and to provide rules for termination of private foundation status by transfer of an organization's net assets to a public charity under section 507(b)(1) of the Code. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, certain changes were made, and the proposed amendments of the regulations, subject to the changes, are adopted by this document. A notice of proposed rule making relating to the defi-

nition of community trusts and termination of private foundation status appears in this issue of the Federal Register (41 FR 50698).

Section 170(b)(1)(A) describes charitable organizations of a public nature, contributions to which generally may be deducted to the extent of 50 percent of an individual donor's income, as compared to 20 percent in the case of certain nonoperating private charities. Section 170(b)(1)(A)(vi) includes in this group of "public" charities those charitable organizations which normally receive a substantial part of their support from a governmental unit or from contributions from the general public. The private foundation provisions of the Tax Reform Act of 1969 (Pub. L. 91-172, 1969-3 C.B. 10) increased the importance of a charitable organization's being described in section 170(b)(1)(A)(i) through (vi) by exempting such organizations from private foundation status. As a result, the regulations under such section were revised in order to provide more explicit rules.

These final regulations contain special rules to determine whether community trusts are "publicly supported" within the meaning of section 170(b)(1)(A)(vi). The regulations provide requirements pursuant to which a community trust will be treated as a single entity. Once a community trust qualifies as a single entity, it can qualify as a "publicly supported" organization by meeting the general public support test. Certain qualifying community trusts which meet another set of requirements may apply for a 5-year transitional ruling period.

The final regulations also contain rules for determining whether a transferor has transferred all the transferor's beneficial interest in transferred assets to a community trust for purpurposes of determining whether such assets shall be treated as a component part of the transferee community trust.

Adoption of amendment to the regulations

Temporary Treasury Regulation § 13.15, added by T.D. 7094 [1971-1 C.B. 97] (36 F.R. 4872), is hereby superseded.

In view of the foregoing, the Income Tax Regulations (26 CFR Part 1) are amended as follows:

Paragraph 1. Immediately after § 1.170A-9(e)(9) insert the following provisions:

(10) *Community trust; introduction.* Community trusts have often been established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area, and often such contributions have come initially from a small number of donors. While the community trust generally has a governing body comprised of representatives of the particular community or area, its contributions are often received and maintained in the form of separate trusts or funds, which are subject to varying degrees of control by the governing body. To qualify as a "publicly supported" organization, a community trust must meet the 33⅓ percent-of-support test of paragraph (e)(2) of this section, or, if it cannot meet that test, be organized and operated so as to attract new and additional public or governmental support on a continuous basis sufficient to meet the facts and circumstances test of paragraph (e)(3) of this section. Such facts and circumstances test includes a requirement of attraction of public support in paragraph (e)(3)(ii) of this section which, as applied to community trusts, will generally be satisfied if they seek gifts and bequests from a wide range of potential donors in the community or area served, through banks or trust companies, through attorneys or other professional persons, or in other appropriate ways which call attention to the community trust as a potential recipient of gifts and bequests made for the benefit of the community or area served. A community trust is not required to engage in periodic, community-wide, fund-raising campaigns directed toward attracting a large number of small contributions in a manner similar to campaigns conducted by a community chest or united fund. Paragraph (e)(12) and (13) of this section provide a transitional ruling period for certain community trusts in existence before November 11, 1976, that had irregular public support, so that they can meet the requirements of paragraph (e)(2) or (3) of this section based on the 4-year computation period described in paragraph (e)(4) of this section. Paragraph (e)(11) of this section provides rules for determining the extent to which separate trusts or funds may be treated as component parts of a community trust, fund or foundation (herein collectively referred to as a "community trust", and sometimes referred to as an "organization") for purposes of meeting the requirements of this paragraph for classification as a "publicly supported" organization. Paragraph (e)(14) of this section contains rules for trusts or funds which are prevented from qualifying as component parts of a community trust by paragraph (e)(11) of this section.

(11) *Community trusts; requirements for treatment as a single entity*—(i) *General rule.* For purposes of sections 170, 501, 507, 508, 509 and chapter 42, any organization that meets the requirements contained in paragraph (e)(11)(iii) through (vi) of this section will be treated as a single entity, rather than as an aggregation of separate funds, and except as otherwise provided, all funds associated with such organization (whether a trust, not-for-profit corporation, unincorporated association, or a combination thereof) which meet the requirements of paragraph (e)(11)(ii) of this section will be treated as component parts of such organization.

(ii) *Component part of a community trust.* In order to be treated as a component part of a community trust referred to in paragraph (e)(11) of this section (rather than as a separate trust or not-for-profit corporation or association) a trust or fund:

(A) Must be created by a gift, bequest, legacy, devise, or other transfer to a community trust which is treated as a single entity under paragraph (e)(11) of this section; and

(B) May not be directly or indirectly subjected by the transferor to any material restriction or condition (within the meaning of § 1.507-2(a)(8)) with respect to the transferred assets.

For purposes of paragraph (e)(11)(ii)(B) of this section, if the transferor is not a private foundation, the provisions of § 1.507-2(a)(8) shall be applied to the trust or fund as if the transferor were a private foundation established and funded by the person establishing the trust or fund and such foundation transferred all its assets to the trust or fund. Any transfer made to a fund or trust which is treated as a component part of a community trust under paragraph (e)(11)(ii) of this section will be treated as a transfer made "to" a "publicly supported" community trust for purposes of section 170(b)(1)(A) and 507(b)(1)(A) if such community trust meets the requirements of section 170(b)(1)(A)(vi) as a "publicly supported" organization at the time of the transfer, except as provided in § 1.170A-9(e)(4)(v)(*b*) or § 1.508-1(b)(4) and (6) (relating, generally, to reliance by grantors and contributors). See, also, paragraph (e)(14)(ii) and (iii) of this section for special provisions relating to split-interest trusts and certain private foundations described in section 170(b)(1)(E)(iii).

(iii) *Name.* The organization must be commonly known as a community trust, fund, foundation or other similar name conveying the concept of a capital or endowment fund to support charitable activities (within the meaning of section 170(c)(1) or (2)(B)) in the community or area it serves.

(iv) *Common instrument.* All funds of the organization must be subject to a common governing instrument or a master trust or agency agreement (herein referred to as the "governing instrument"), which may be embodied in a single document or several documents containing common language. Language in an instrument of transfer to the community trust making a fund subject to the community trust's governing instrument or master trust or agency agreement will satisfy the requirements of paragraph (e)(11)(iv) of this section.

(v) *Common governing body.* (A) The organization must have a common governing body or distribution committee (herein referred to as the "governing body") which either directs, or, in the case of a fund designated for specified beneficiaries, monitors the distribution of all of the funds exclusively for charitable purposes (within the meaning of section 170(c)(1) or (2)(B)). For purposes of this (v) a fund is designated for specified beneficiaries only if no person is left with the discretion to direct the distribution of the fund.

(B) [Reserved]

(vi) *Common reports.* The organization must prepare periodic financial reports treating all of the funds which are held by the community trust, either directly or in component parts, as funds of the organization.

(vii) *Transitional rule.* If the governing instrument of a community trust (or an instrument of transfer) is inconsistent with the requirements of paragraph (e)(11)(iv) or (v) of this section but with respect to gifts or bequests acquired before January 1, 1982, the community trust changes its governing instrument (or instrument of transfer) by the later of November 11, 1977, or one year after the gift or bequest is acquired, in order to conform such instrument to such provisions, then such an instrument shall be treated as consistent with paragraph (e)(11)(iv) or (v) of this section for taxable years beginning after December 31, 1969. In addition, if prior to the later of such dates, the organization has instituted court proceedings in order to conform such an instrument, then it may apply (prior to the later of such dates) for an extension of the period to conform such instrument to such provisions. Such application shall be made to the Commissioner of Internal Revenue, Attention: E:EO, Washington, D.C. 20224. The Commissioner, at the Commissioner's discretion, may grant such an extension, if in the Commissioner's opinion such a change will conform the instrument to such provisions and will be made within a reasonable time.

(12) *Community trusts qualifying for 5-year transitional ruling period—* (i) *In general.* Paragraph (e)(12) and (13) of this section contain transitional rules for certain community trusts in existence before November 11, 1976 which are unable to meet the requirements of paragraph (e)(2) or (3) of this section based upon a 4-year computation period under paragraph (e)(4) of this section. A community trust that satisfies the requirements of paragraph (e)(12)(ii) of this section will be eligible for a transitional ruling or determination letter that it will be treated as a section 170(b)(1)(A)(vi) organization for a 5-year transitional ruling period (referred to in this section as a "transitional ruling or determination letter"). These transitional rules apply to—

(A) A community trust which has been in existence less than 9 taxable years before November 11, 1976; and

(B) Other community trusts that for each taxable year beginning after December 31, 1969, and before January 1, 1978, qualify as "publicly supported" under paragraph (e)(2) or

(3) of this section based upon a computation period of either—

(*1*) 10 taxable years, or

(*2*) The number of taxable years (but not more than 20 nor less than 10) preceding such taxable year that the organization was in existence.

For special rules in applying the requirements of paragraph (e)(2) or (3) of this section based upon such computation periods, see paragraph (e)(12)(v) of this section. For purposes of paragraph (e)(12) of this section the initial taxable year of the 5-year transitional ruling period (hereinafter referred to as the "transitional ruling period") shall be the organization's taxable year beginning in 1977, and (unless terminated earlier) the last year of the transitional ruling period is the organization's taxable year which begins in 1981.

(ii) *Transitional 5-year ruling.* (A) If a community trust meets the requirements of paragraph (e)(11), (12) and (13) of this section and can reasonably be expected to meet the requirements of paragraph (e)(2) or (3) of this section—

(*1*) For each of its taxable years (if such a year begins after its tenth taxable year) beginning in 1978, 1979, 1980 and 1981 based upon a 10-year computation period, and

(*2*) For its taxable year beginning in 1982 based upon a 4-year computation period under paragraph (e)(4) of this section;

it may, at the discretion of the Commissioner, receive a transitional ruling or determination letter for the transitional ruling period.

(B)(*1*) However, if for the taxable year beginning in 1977, a community trust can meet the requirements of paragraph (e)(12)(i)(B) of this section only by using the computation period of its existence described in paragraph (e)(12)(i)(B)(*2*) of this section, then the community trust may meet the requirements of paragraph (e)(12)(ii)(A)(*1*) of this section if it is reasonably expected to meet the requirements of paragraph (e)(2) or (3) of this section for each of its taxable years beginning in 1978, 1979, 1980 and 1981 based upon a computation period consisting of the number of taxable years (but not more than 20 nor less than 10) preceding such taxable year that the organization was in existence.

(*2*) In the case of a community trust that will not have been in existence more than ten taxable years as of its taxable year beginning in 1981, a transitional ruling or determination letter for the transitional ruling period will not be granted unless the community trust can reasonably be expected to meet the requirements of paragraph (e)(2) or (3) of this section for its taxable year beginning in 1982 based upon a 4-year computation period under paragraph (e)(4) of this section and also a computation period consisting of the taxable years the organization has been in existence (other than the organization's taxable year beginning in 1982).

(C) A community trust that is eligible for a transitional ruling or determination letter must apply with the district director for such ruling or determination letter within one year after November 11, 1976. A transitional ruling or determination letter will be granted only if the requesting organization files with its request for such ruling or determination letter a consent letter under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for all taxable years beginning before January 1, 1982 during the transitional ruling period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for its taxable year beginning in 1981. The provisions of paragraph (e)(5)(iii) of this section (relating to reliance upon ruling) shall apply with respect to a community trust which receives a transitional ruling or determination letter and with respect to its grantors and contributors, except that the transitional ruling period described in paragraph (e)(12)(ii) of this section shall be substituted for the advance ruling period described in paragraph (e)(5)(i)or (iv) of this section.

(D) A community trust does not have to meet the requirements of paragraph (e)(13) of this section for taxable years beginning prior to the date of its application for a transitional ruling or determination letter or for any taxable year beginning after the expiration or termination of its transitional ruling or determination letter. In applying paragraph (e)(13) of this section to organizations applying for a transitional ruling or determination letter, paragraph (e)(13)(x) and (xii) of this section (relating to unrestricted gifts and excess holdings, respectively) shall be applied without regard to assets acquired prior to November 11, 1976. In addition, if within 1 year from acquiring any asset, the community trust removes any restriction inconsistent with paragraph (e)(13) of this section, such asset shall be treated as if it were not subject to such restriction as of the time it was acquired. Since under paragraph (e)(12)(ii)(D) of this section, a community trust does not have to meet the requirements of paragraph (e)(13) of this section for taxable years beginning prior to the date of its application for the transitional ruling or determination letter, then if the community trust makes such application in its taxable year beginning in 1977 and its terminates such ruling or determination letter in such year as well, such a community trust does not have to meet such requirements for any taxable year.

(E) After the transitional ruling or determination letter of an organization has expired or been terminated under paragraph (e)(12)(iii) of this section, the organization must qualify as a "publicly supported" organization pursuant to the rules set forth in para-

graph (e)(1) through (11) of this section. Thus, since the transitional ruling period of a community trust expires with its taxable year beginning in 1981, for its taxable year beginning in 1982 and thereafter, the community trust must meet the requirements of paragraph (e)(2) or (3) of this section based upon the 4-year computation period under paragraph (e)(4) of this section.

(iii) *Termination of transitional ruling.* (A) The transitional ruling or determination letter issued under this paragraph is subject to termination under paragraph (e)(12)(iii)(B) or (D) of this section without a request from the organization. In addition, such a ruling or determination letter is subject to termination under paragraph (e)(12)(iii)(E) of this section at the request of the organization. A transitional ruling or determination letter is subject to termination for any taxable year beginning after December 31, 1976, and before January 1, 1982, under paragraph (e)(12)(iii)(B), (D) or (E) of this section.

(B) The transitional ruling or determination letter issued under this paragraph shall be terminated for any taxable year (if such a year begins after its tenth taxable year) beginning in 1978, 1979, 1980 or 1981 for which a community trust receiving such a ruling or determination letter fails to meet the requirements of paragraph (e)(2) or (3) of this section for a 10-year computation period, except as provided in paragraph (e)(12)(iii)(C) of this section.

(C) In applying paragraph (e)(12)(iii)(B) of this section to a community trust described in paragraph (e)(12)(ii)(B)(*1*) of this section, a computation period consisting of the number of taxable years (but not more than 20 nor less than 10) preceding such taxable year that the organization has been in existence shall be substituted for the 10-year computation period until the first taxable year beginning in 1978, 1979, 1980 or 1981 that the community trust can meet the requirements of paragraph (e)(2) or (3) of this section based upon a 10-year computation period.

(D) The Commissioner may, at the discretion of the Commissioner, terminate the transitional ruling or determination letter of any community trust for any taxable year beginning prior to January 1, 1982, for which the organization fails to meet the requirements of paragraph (e)(11), (12) or (13) of this section, as provided in paragraph (e)(12)(ii) of this section.

(E) A community trust may request an immediate termination of the community trust's transitional ruling or determination letter in order that, for the current taxable year, it may be determined if such community trust meets the requirements of paragraph (e)(2) or (3) of this section based upon a 4-year computation period under paragraph (e)(4) of this section. Such a request shall be granted and the transitional ruling or determination letter terminated only if the community trust meets such requirements, and in the case of an organization that has been in existence less than 11 taxable years at the time of such request, the organization also meets the requirements of paragraph (e)(2) or (3) of this section for the computation period consisting of the taxable years that the organization has been in existence.

(iv) *Initial determination of status.* (A) The initial determination of status of a community trust is the first determination (other than by issuance of an advance ruling or determination letter under paragraph (e)(5) or a transitional ruling or determination letter under paragraph (e)(12)(ii) of this section) that the community trust will be considered as "normally" meeting the requirements of paragraph (e)(2) or (3) of this section for a period beginning with its first taxable year.

(B)(*1*) In the case of a community trust described in paragraph (e)(12)(i)(B) of this section, the initial determination of status shall be made for the community trust's taxable year beginning in 1977 if such community trust has met the requirements of paragraph (e)(2) or (3) of this section for its taxable year beginning in 1977, based upon a 10-year computation period.

(*2*) In the case of any other community trust described in paragraph (e)(12)(i)(B) of this section (but not described in paragraph (e)(12)(iv)(B)(*1*) of this section), the initial determination of status shall be made for its first taxable year beginning after December 31, 1976, and before January 1, 1982, for which it meets the requirements of paragraph (e)(2) or (3) of this section based upon a 10-year computation period (if the community trust has received a transitional ruling or determination letter that has not been terminated before such taxable year).

(C) In the case of a community trust described in paragraph (e)(12)(i)(A) of this section (relating to an organization in existence less than 9 taxable years) that reaches its 11th taxable year before its taxable year beginning in 1982, its initial determination of status shall be for its 11th taxable year based upon a 10-year computation period (if it has received a transitional ruling or determination letter that has not been terminated before such taxable year).

(D) If a community trust has not received an initial determination of status prior to the expiration or termination of its transitional ruling period, the initial determination of status shall be made—

(*1*) In the case of an expiration, for the taxable year beginning in 1982, or

(*2*) In the case of a termination, for the last taxable year of the terminated transitional period,

based upon a 4-year computation period under paragraph (e)(4) of this section. In the case of an organization that has been in existence less than 11

taxable years at such time, the initial determination of status shall also be based upon a computation period consisting of the taxable years it has been in existence. For example, if the initial determination of status (for an organization that has been in existence for at least 11 taxable years) is made for its taxable year beginning in 1982, then, except as provided in paragraph (e)(4)(v) of this section (relating to exception for material changes of support), such determination shall be based upon a 4-year computation period ending with the taxable year beginning in 1980 or 1981 (treating the taxable year beginning in 1982, as the subsequent year or current year, respectively).

On the other hand, if, for example, the transitional ruling or determination letter is terminated in the taxable year beginning in 1980, then, except as provided in such paragraph (e)(4)(v), the initial determination of status shall be made for the taxable year beginning in 1980 based upon the 4-year computation period ending with the taxable year beginning in 1978 or 1979.

(v) *Special rules*—(A) *Consequences of organization failing to meet requirements at end of transitional period.* If upon the expiration (or termination) of the transitional period an organization with a transitional ruling or determination letter fails to meet the requirements of paragraph (e)(2) or (3) of this section based upon the 4-year computation period of paragraph (e)(4) of this section, it shall not be treated as an organization described in section 170(b)(1)(A)(vi) for its taxable year beginning in 1982 (or for the last taxable year of its terminated transitional period, as the case may be). If, by reason of failing to qualify as an organization described in section 170(b)(1)(A)(vi), such organization becomes a private foundation, then the organization will be a private foundation for its taxable year beginning in 1982 (or the last taxable year of its terminated transitional period, as the case may be) and all subsequent taxable years, unless and until it terminates its status under section 507. In addition, such an organization is a private foundation for all taxable years beginning prior to its taxable year beginning in 1982 (or for the last taxable year of the terminated transitional period, as the case may be), except—

(*1*) That if the organization had received an initial determination of status that it met the requirements of paragraph (e)(2) or (3) of this section, then the organization will be treated as "publicly supported" for the taxable years to which the initial determination of status is effective, as well as for all taxable years beginning after the last of such years and before January 1, 1982, for which the organization consecutively meets the requirements of paragraph (e)(2) or (3) of this section based upon a 10-year computation period,

(*2*) That in the case of an organization that has reached its tenth taxable year of existence before January 1, 1970, if the organization has not received an initial determination of status prior to its taxable year beginning in 1982, then the organization will be treated as "publicly supported" for each taxable year beginning before January 1, 1977, that the organization, beginning with the taxable year beginning in 1970, consecutively met the requirements of paragraph (e)(2) or (3) of this section based upon a 10-year computation period, or

(*3*) That in the case of an organization whose 11th taxable year of its existence began after December 31, 1970 and before January 1, 1977, if the organization has not received an initial determination of status prior to its taxable year beginning in 1982, but the organization for its 11th taxable year of existence met the requirements of paragraph (e)(2) or (3) of this section based upon a 10-year computation period, then the organization will be treated as "publicly supported" for the first 12 taxable years of its existence. In addition, such an organization will be so treated for its 13th taxable year and each subsequent taxable year (if such a year begins before January 1, 1977) that the organization, beginning with its 12th taxable year, consecutively met the requirements of paragraph (e)(2) or (3) of this section based upon a 10-year computation period.

(*4*) To the extent provided in paragraph (e)(4)(vii) of this section (relating to special rule for organization with existing rulings), § 1.508-1(b) (relating to notice that an organization is not a private foundation) or § 1.509(a)-7 (relating to reliance by grantors and contributors to section 509(a)(1), (2), and (3) organizations).

(B) *Computation period.* In applying the requirements of paragraph (e)(2) or (3) of this section to a 10-year or other computation period under paragraph (e)(12) or (13) of this section, such 10-year or other computation period shall be substituted for the 4-year computation period of paragraph (e)(4) of this section. Thus, for example, an organization will (except as provided in paragraph (e)(4)(v) of this section relating to exception for material changes in sources of support) meet the "publicly supported" test of this paragraph for the taxable year beginning in 1977 based upon a 10-year computation period, if it met the requirements of paragraph (e)(2) or (3) of this section for a computation period consisting of either the taxable years beginning in the years 1966 through 1975 or the years 1967 through 1976, since under paragraph (e)(4) of this section, meeting the requirements for a computation period is effective for the current taxable year and the immediately succeeding taxable year. However, in substituting

a 10-year or other computation period for the 4-year computation period of paragraph (e)(4) of this section, the rules of such paragraph (e)(4) and (6) apply, including the 2-percent limitation under paragraph (e)(6)(i) of this section and the exclusion for unusual grants under paragraph (e)(6)(ii) of this section. In applying such provisions, the fact that the computation period is other than a 4-year computation period shall be taken into account, so that, for example, the 2-percent limitation shall be applied, in the case of a 10-year computation period, with reference to 2 percent of the organization's total support for the 10-year computation period rather than a 4-year computation period. In addition, in substituting a 10-year or other computation period for purposes of paragraph (e)(3) of this section, all of the facts and circumstances referred to in such paragraph (e)(3) shall be considered with respect to such period, viewing such period as a whole. See, also, paragraph (e)(10) of this section with respect to the organization being organized and operated to attract public support.

(C) *First taxable year of less than 8 months.* In the case of an organization whose first taxable year consisted of less than 8 months, in order to coordinate the rules of paragraph (e)(12) of this section with the rules of paragraph (e)(5) of this section, in applying the rules of paragraph (e)(12) of this section, such an organization shall be treated as organized at the beginning of its succeeding taxable year, so that such succeeding taxable year shall be treated as its first taxable year of existence. However, the support received for the period preceding such succeeding taxable year shall be taken into account with the support received in such succeeding taxable year.

(13) *Community trusts; requirements for 5-year transitional ruling period*—(i) *In general.* In order for a community trust to be eligible for a transitional ruling or determination letter for the transitional ruling period under paragraph (e)(12) of this section, it must establish that it is organized, and will be operated, in such manner that it can reasonably be expected to meet the requirements of paragraph (e)(13) of this section, and can reasonably be expected to meet the requirements of paragraph (e)(2) or (3) of this section, for each taxable year during and immediately following the transitional ruling period, as provided in paragraph (e)(12)(ii) of this section. In determining whether an organization can reasonably be expected to meet the requirements of paragraph (e)(2) or (3) of this section for each such taxable year, the basic consideration is whether its organizational structure, proposed programs or activities, and intended method of operation are such as to attract the type of broadly based support from the general public, public charities, and governmental units which is necessary to meet such tests. The information to be considered for this purpose shall consist of all pertinent facts and circumstances relating to the requirements set forth in paragraph (e)(3) of this section. For purposes of meeting the requirements of paragraph (e)(13) of this section, a community trust may, prior to its application for a transitional ruling or determination letter under paragraph (e)(12)(ii)(C) of this section, adopt a resolution stating that, as a matter of policy, it will attempt to meet the conditions set forth in paragraph (e)(13) of this section during the transitional ruling period. A community trust will not be treated as failing to satisfy the requirements of paragraph (e)(13) of this section merely because the governing body, or any of its trustees, agents, or custodians, fails to meet one or more of the requirements contained in paragraph (e)(13)(ii) through (xiii) of this section by reason of isolated and nonrepetitive acts. However, any continuing pattern on the part of the governing body, or its trustees, agents or custodians, indicating a continued and repetitive failure to comply with a policy of meeting such requirements will result in termination of the transitional ruling or determination letter under paragraph (e)(12)(iii)(D) of this section.

(ii) *Area.* The community trust is organized and operated exclusively to carry out charitable purposes (within the meaning of section 170(c)(1) or (2)(B)) primarily within a broad geographical area which it serves, such as a municipality, county, metropolitan area, State or region.

(iii) *General composition of governing body.* The governing body must represent the broad interests of the public rather than the personal or private interests of a limited number of donors. An organization will be treated as meeting this requirement if it has a governing body comprised of public officials acting in their capacities as such; individuals selected by public officials acting in their capacities as such; persons having special knowledge or expertise in a particular field or discipline in which the community trust operates; community leaders, such as elected or appointed officials, clergymen, educators, civic leaders; or other such persons representing a broad cross-section of the views and interests of the area served.

(iv) *Rules for governing body.* With respect to terms of office beginning after the date of the application of the community trust for a transitional ruling or determination letter—

(A) Its governing body is comprised of members who may serve a period of not more than ten consecutive years;

(B) Upon completion of a period of service (beginning before or after such date) no person may serve within a period consisting of the lesser of 5 years or the number of consecutive

years the member has immediately completed serving;

(C) Persons who would be described in section 4946(a)(1)(A) or (C) through (G) if the community trust were a private foundation do not constitute more than one-third of its governing body; and

(D) Representatives of banks or trust companies which serve as trustees, investment managers, custodians, or agents, plus persons described in paragraph (e)(13)(iv)(C) of this section, do not constitute a majority of the governing body.

No term of office beginning on or before the date of such application may continue for more than 10 years from such date.

(v) *Fiduciary responsibility.* Fiduciary responsibility with respect to the funds of the community trust is imposed, either by the master trust or agency agreement or by State law, on either its governing body or its trustee banks or trust companies or both.

(vi) *Ultimate control of assets.* Neither its governing body, nor any of its trustees, investment managers, custodians or agents may be subjected by any donor to the community trust to any material condition or restriction within the meaning of § 1.507-2(a)(8) which would prevent it from exercising ultimate control over its assets.

(vii) *Administration.* Administration and investment of all gifts and bequests are accomplished through:

(A) A governing body which directly holds, administers or invests such gifts and bequests exclusively for charitable purposes;

(B) Banks or trust companies (acting or appointed as trustees), investment managers, custodians or agents of the community trust or one or more components thereof; or

(C) A combination of such persons.

(viii) *Annual distributions.* It makes annual distributions for purposes described in section 170(c)(1) or (2)(B), including administrative expenses and amounts paid to acquire an asset used (or held for use) directly in carrying out one or more of such purposes, in an amount not less than its adjusted net income (as defined in section 4942(f)). For purposes of paragraph (e)(13)(viii) of this section, the term "distributions" shall include amounts set aside for a specific project, but only if prior to making the set-aside the organization has, pursuant to a request for a ruling, established to the satisfaction of the Commissioner that:

(A) The amount will be paid for the specific project within 5 years; and

(B) The project is one which can be better accomplished by such set-aside than by immediate distribution of funds.

All annual distributions required to be made pursuant to paragraph (e)(13)(viii) of this section, except for set-asides, must be made no later than the close of the organization's first taxable year after the taxable year for which the adjusted net income is computed. Thus, in the case of a calendar year community trust which has received a transitional ruling or determination letter upon an application made in 1977, it must make distributions under paragraph (e)(13)(vii) of this section for 1978, 1979, 1980 and 1981 based upon its adjusted net income for 1977, 1978, 1979 and 1980, respectively, unless its transitional ruling or determination letter is terminated. If such a community trust's transitional ruling or determination letter is terminated in 1979, it must make distributions under paragraph (e)(13)(viii) of this section only for 1978 based upon its adjusted net income for 1977. On the other hand, if such ruling or letter is terminated in 1977 or 1978, no distribution under paragraph (e)(13)(viii) of this section need be made.

(ix) *Net income.* The community trust's funds must, on an aggregate basis, be invested to produce an annual adjusted net income (as defined in section 4942(f)) of not less than two-thirds of what would be its minimum investment return (within the meaning of section 4942(e)) if such organization were a private foundation.

(x) *Unrestricted gifts.* At least one-half of the total income which the comunity trust derives from the investment of gifts and bequests received must be unrestricted (within the meaning of this (x)) with respect to its availability for distribution by the governing body. For purposes of this (x), any income which has been designated by the donor of the gift or bequest to which such income is attributable as being available only for the use or benefit of a broad charitable purpose, such as the encouragement of higher education or the promotion of better health care in the community, will be treated as unrestricted. However, any income which has been designated for the use or benefit of a named charitable organization or agency or for the use or benefit of a particular class of charitable organizations or agencies, the members of which are readily ascertainable and are less than five in number, will be treated as restricted.

(xi) *Self-dealing.* The community trust may not engage in any act with any person (other than a foundation manager acting only in such capacity) which would constitute self-dealing within the meaning of section 4941 if such community trust were a private foundation.

(xii) *Excess holdings.* The community trust must dispose of any holdings which would constitute excess business holdings (within the meaning of section 4943—applied on a component-by-component basis as if each component were a private foundation, except that components will be combined for purposes of this paragraph if such components would

have been described in section 4946 (a)(1)(H)(ii)).

(xiii) *Expenditure responsibility.* The community trust must exercise expenditure responsibility (within the meaning of section 4945(h)) through either its governing body, trustees, investment managers, custodians, or agents with respect to any grant which would otherwise constitute a taxable expenditure under section 4945(d)(4) if the community trust were a private foundation, except that it need not make the reports required of private foundations by section 4945(h)(3).

(14) *Community trusts; treatment of trusts and not-for-profit corporations and associations not included as components.* (i) For purposes of sections 170, 501, 507, 508, 509 and chapter 42, any trust or not-for-profit corporation or association which is alleged to be a component part of a community trust, but which fails to meet the requirements of paragraph (e)(11)(ii) of this section, shall not be treated as a component part of a community trust and, if a trust, shall be treated as a separate trust and be subject to the provisions of section 501 or section 4947(a)(1) or (2), as the case may be. If such organization is a not-for-profit corporation or association, it will be treated as a separate entity, and, if it is described in section 501(c)(3), it will be treated as a private foundation unless it is described in section 509(a)(1), (2), (3), or (4). Any transfer made in connection with the creation of such separate trust or not-for-profit organization, or to such entity, will not be treated as being made "to" the community trust or one of its components for purposes of sections 170(b)(1)(A) and 507(b)(1)(A) even though a deduction with respect to such transfer is allowable under § 1.170-1(e), § 20.2055-2(b), or § 25.2522(a)-2(b), unless such treatment is permitted under § 1.170A-9(e)(4)(v)(*b*) or § 1.508-1(b)(4). In the case of a fund which is ultimately treated as not being a component part of a community trust pursuant to paragraph (e)(14) of this section, if the Forms 990 filed annually by the community trust included financial information with respect to such fund and treated such fund in the same manner as other component parts thereof, such returns filed by the community trust prior to the taxable year in which the Commissioner notifies such fund that it will not be treated as a component part will be treated as its separate return for purposes of subchapter A of chapter 61 of Subtitle F, and the first such return filed by the community trust will be treated as the notification required of the separate entity for purposes of section 508(a).

(ii) If a transfer is made in trust to a community trust to make income or other payments for a period of a life or lives in being or a term of years to any individual or for any noncharitable purpose, followed by payments to or for the use of the community trust (such as in the case of a charitable remainder annuity trust or a charitable remainder unitrust described in section 664 or a pooled income fund described in section 642(c)(5)), such trust will be treated as a component part of the community trust upon the termination of all intervening noncharitable interests and rights to the actual possession or enjoyment of the property if such trust satisfies the requirements of paragraph (e)(11) of this section at such time. Until such time, the trust will be treated as a separate trust. If a transfer is made in trust to a community trust to make income or other payments to or for the use of the community trust, followed by payments to any individual or for any noncharitable purpose, such trust will be treated as a separate trust rather than as a component part of the community trust. See section 4947(a)(2) and the regulations thereunder for the treatment of such split-interest trusts. The provisions of this (ii) only provide rules for determining when a charitable remainder trust or pooled income fund may be treated as a component part of a community trust and are not intended to preclude a community trust from maintaining a charitable remainder trust or pooled income fund. Thus, for purposes of grantors and contributors, a pooled income fund of a "publicly supported" community trust shall be treated no differently than a pooled income fund of any other "publicly supported" organization.

(iii) An organization described in section 170(b)(1)(E)(iii) will not ordinarily satisfy the requirements of paragraph (e)(11)(ii) of this section because of the unqualified right of the donor to designate the recipients of the income and principal of the trust. Such organization will therefore ordinarily be treated as other than a component part of a community trust under paragraph (e)(14)(i) of this section. However, see section 170(b)(1)(E)(iii) and the regulations thereunder with respect to the treatment of contributions to such organizations.

Par. 2. Section 1.507-2 is amended by revising paragraph (a)(5)(ii) and the first sentence of paragraph (b)(3) and by adding paragraph (a)(8) to read as follows:

§ 1.507-2 Special rules; transfer to, or operation as, public charity.

(a) *Transfer to public charities.* * * *

(5) *Special transitional rule.* * * *

(ii) The period referred to in subdivision (i) of this subparagraph is the 12-month period beginning with the first day of the organization's first taxable year which begins after December 31, 1969, but such period shall not be treated as ending before February 20, 1973. In the case of a private foundation distributing assets pursuant to section 507(b)(1)(A) to a medical research organization or a community trust (or in the case of a private foundation seeking to terminate into such an organization or trust pursuant to section 507(b)(1)(B)), the period de-

scribed in this subdivision shall be treated as not ending before—

(A) In the case of a distribution to a medical research organization, March 29, 1976; or

(B) In the case of a community trust, May 11, 1977.

* * * * *

(8) *Effect of restrictions and conditions upon distributions of net assets*—(i) *In general.* In order to effectuate a transfer of "all of its right, title, and interest in and to all of its net assets" within the meaning of paragraph (a)(7) of this section, a transferor private foundation may not impose any material restriction or condition that prevents the transferee organization referred to in section 507(b)(1)(A) (herein sometimes referred to as the "public charity") from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes. Whether or not a particular condition or restriction imposed upon a transfer of assets is "material" (within the meaning of paragraph (a)(8) of this section) must be determined from all of the facts and circumstances of the transfer. Some of the more significant facts and circumstances to be considered in making such a determination are:

(A) Whether the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the owner in fee of the assets it receives from the private foundation;

(B) Whether such assets are to be held and administered by the public charity in a manner consistent with one or more of its exempt purposes;

(C) Whether the governing body of the public charity has the ultimate authority and control over such assets, and the income derived therefrom; and

(D) Whether, and to what extent, the governing body of the public charity is organized and operated so as to be independent from the transferor.

(ii) *Independent governing body.* As provided in paragraph (a)(8)(i)(D) of this section, one of the more significant facts and circumstances to be considered in making the determination whether a particular condition or restriction imposed upon a transfer of assets is "material" within the meaning of paragraph (a)(8) of this section is whether, and the extent to which, the governing body is organized and operated so as to be independent from the transferor. In turn, the determination as to such factor must be determined from all of the facts and circumstances. Some of the more significant facts and circumstances to be considered in making such a determination are:

(A) Whether, and to what extent, members of the governing body are comprised of persons selected by the transferor private foundation or disqualified persons with respect thereto, or are themselves such disqualified persons;

(B) Whether, and to what extent, members of the governing body are selected by public officials acting in their capacities as such; and

(C) How long a period of time each member of the governing body may serve as such. In the case of a transfer that is a community trust, the community trust shall meet paragraph (a)(8)(ii)(C) of this section if it meets the requirements of § 1.170A-9(e)(13)(iv) (other than § 1.170A-9(e)(13)(iv)(C) or (D)), relating to rules for governing body.

(iii) *Factors not adversely affecting determination.* The presence of some or all of the following factors will not be considered as preventing the transferee "from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes" (within the meaning of paragraph (a)(8)(i) of this section):

(A) *Name.* The fund is given a name or other designation which is the same as or similar to that of the transferor private foundation or otherwise memorializes the creator of the foundation or his family.

(B) *Purpose.* The income and assets of the fund are to be used for a designated purpose or for one or more particular section 509(a)(1), (2), or (3) organizations, and such use is consistent with the charitable, educational, or other basis for the exempt status of the public charity under section 501(c)(3).

(C) *Administration.* The transferred assets are administered in an identifiable or separate fund, some or all of the principal of which is not to be distributed for a specified period, if the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the legal and equitable owner of the fund and the governing body exercises ultimate and direct authority and control over such fund, as, for example, a fund to endow a chair at a university or a medical research fund at a hospital. In the case of a community trust, the transferred assets must be administered in or as a component part of the community trust within the meaning of § 1.170A-9(e)(11).

(D) *Restrictions on disposition.* The transferor private foundation transfers property the continued retention of which by the transferee is required by the transferor if such retention is important to the achievement of charitable or other similar purposes in the community because of the peculiar features of such property, as, for example, where a private foundation transfers a woodland preserve which is to be maintained by the public charity as an arboretum for the benefit of the community. Such a restriction does not include a restriction on the disposition of an investment asset or the distribution of income.

(iv) *Adverse factors.* The presence of any of the following factors will be considered as preventing the trans-

feree "from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes" (within the meaning of paragraph (a)(8)(i) of this section):

(A) *Distributions.* The transferor private foundation, a disqualified person with respect thereto, or any person or committee designated by, or pursuant to the terms of an agreement with, such a person, reserves the right, directly or indirectly, to name (other than by designation in the instrument of transfer of particular section 509 (a)(1), (2), or (3) organizations) the persons to which the transferee public charity must distribute, or to direct the timing of such distributions (other than by direction in the instrument of transfer that some or all of the principal, as opposed to specific assets, not be distributed for a specified period) as, for example, by a power of appointment. The Internal Revenue Service will examine carefully whether the seeking of advice by the transferee from, or the giving of advice by, any person referred to in the preceding sentence after the assets have been transferred to the transferee constitutes an indirect reservation of a right to direct such distributions. Moreover, solicitations (written or oral) of funds by the public charity which state or imply that a donor's advice may be followed will be closely scrutinized to determine whether there is reservation of such a right.

(B) *Other action or withholding of action.* The terms of the transfer agreement, or any expressed or implied understanding, require the public charity to take or withhold action with respect to the transferred assets which is not designed to further one or more of the exempt purposes of the public charity, and such action or withholding of action would, if performed by the transferor private foundation with respect to such assets, have subjected the transferor to tax under chapter 42 (other than with respect to the minimum investment return requirement of section 4942(e)).

(C) *Assumption of leases, etc.* The public charity assumes leases, contractual obligations, or liabilities of the transferor private foundation, or takes the assets thereof subject to such liabilities (including obligations under commitments or pledges to donees of the transferor private foundation), for purposes inconsistent with the purposes or best interests of the public charity, other than the payment of the transferor's chapter 42 taxes incurred prior to the transfer to the public charity to the extent of the value of the assets transferred.

(D) *Retention of investment assets.* The transferee public charity is required by any restriction or agreement (other than a restriction or agreement imposed or required by law or regulatory authority), express or implied, to retain any securities or other investment assets transferred to it by the private foundation. In a case where such transferred assets consistently produce a low annual return of income, the Internal Revenue Service will examine carefully whether the transferee is required by any such restriction or agreement to retain such assets.

(E) *Right of first refusal.* An agreement is entered into in connection with the transfer of securities or other property which grants directly or indirectly to the transferor private foundation or any disqualified person with respect thereto a right of first refusal with respect to the transferred securities or other property when and if disposed of by the public charity, unless such securities or other property was acquired by the transferor private foundation subject to such right of first refusal prior to October 9, 1969.

(F) *Relationships.* An agreement is entered into between the transferor private foundation and the transferee public charity which establishes irrevocable relationships with respect to the maintenance or management of assets transferred to the public charity, such as continuing relationships with banks, brokerage firms, investment counselors, or other advisors with regard to the investments or other property transferred to the public charity (other than a relationship with a trustee, custodian, or agent for a community trust acting as such). The transfer of property to a public charity subject to contractual obligations which were established prior to November 11, 1976 between the transferor private foundation and persons other than disqualified persons with respect to such foundation will not be treated as prohibited under the preceding sentence, but only if such contractual obligations were not entered into pursuant to a plan to terminate the private foundation status of the transferor under section 507(b)(1)(A) and if the continuation of such contractual obligations is in the best interests of the public charity.

(G) *Other conditions.* Any other condition is imposed on action by the public charity which prevents it from exercising ultimate control over the assets received from the transferor private foundation for purposes consistent with its exempt purposes.

(v) *Examples.* The provisions of paragraph (a)(8) of this section may be illustrated by the following examples:

Example (1). The M Private Foundation transferred all of its net assets to the V Cancer Institute, a public charity described in section 170(b)(1)(A)(iii). Prior to the transfer, M's activities consisted of making grants to hospitals and universities to further research into the causes of cancer. Under the terms of the transfer, V is required to keep M's assets in a separate fund and use the income and principal to further cancer research. Although the assets may be used only for a limited purpose, this purpose is consistent with and in furtherance of V's exempt purposes, and does not prevent the transfer from being a distribution for purposes of section 507(b)(1)(A).

Example (2). The N Private Foundation transferred all of its net assets to W University, a public charity described in section 170(b)(1)(A)(ii). Under the terms of the transfer, W is required to use the income and principal to endow a chair at the university to be known as the "John J. Doe

Memorial Professorship", named after N's creator. Although the transferred assets are to be used for a specified purpose by W, this purpose is in furtherance of W's exempt educational purposes, and there are no conditions on investment or reinvestment of the principal or income. The use of the name of the foundation's creator for the chair is not a restriction which would prevent the transfer from being a distribution for purposes of section 507(b)(1)(A).

Example (3). The O Private Foundation transferred all of its net assets to X Bank as trustee for the P Community Trust, a community trust which is a public charity described in section 170(b)(1)(A)(vi). Under the terms of the transfer, X is to hold the assets in trust for P and is directed to distribute the income annually to the Y Church, a public charity described in section 170(b)(1)(A)(i). The distribution of income to Y Church is consistent with P's exempt purposes. If the trust created by this transfer otherwise meets the requirements of § 1.170A-9(e)(11) as a component part of P Community Trust, the assets transferred by O to X will be treated as distributed to one or more public charities within the meaning of section 507(b)(1)(A). The direction to distribute the income to Y Church meets the conditions of paragraph (a)(8)(iii)(B) of this section and will therefore not disqualify the transfer under section 507(b)(1)(A).

Example (4). The U Private Foundation transferred all of its net assets to Z Bank as trustee for the R Community Trust, a community trust which is a public charity described in section 170(b)(1)(A)(vi). Under the terms of the transfer, Z is to hold the assets in trust for R and distribute the income to those public charities described in section 170(b)(1)(A)(i) through (vi) that are designated by B, the creator of U. R's governing body has no authority during B's lifetime to vary B's direction. Under the terms of the transfer, it is intended that Z retain the transferred assets in their present form for a period of 20 years, or until the date of B's death if it occurs before the expiration of such period. Upon the death of B, R will have the power to distribute the income to such public charities as it selects and may dispose of the corpus as it sees fit. Under paragraph (a)(8)(iv)(A) or (D) of this section, as a result of the restrictions imposed with respect to the transferred assets, there has been no distribution of all U's net assets within the meaning of section 507(b)(1)(A) at the time of the transfer. In addition, U has not transferred its net assets to a component part of R Community Trust, but rather to a separate trust described in § 1.170A-9(e)(14).

* * * * *

(vi) *Transitional rule.* If the governing instrument of the public charity (or an instrument of transfer) lacks the factors described in paragraph (a)(8)(i)(D) or (ii) of this section, but with respect to gifts or bequests acquired before January 1, 1982, the public charity changes its governing instrument (or instrument of transfer) by the later of November 11, 1977, or one year after the gift or bequest is acquired, in order to conform such instrument to such provisions, then such an instrument shall be treated as consistent with such provisions for taxable years beginning prior to the date of change. In addition, if prior to the later of such dates, the organization has instituted court proceedings in order to conform such an instrument, then it may apply (prior to the later of such dates) for an extension of the period to conform such instrument to such provisions. Such application shall be made to the Commissioner of Internal Revenue, Attention E:EO, Washington, D.C. 20224. The Commissioner, at the Commissioner's discretion, may grant such an extension, if in the Commissioner's opinion such a change will conform the instrument to such provisions, and the change will be made within a reasonable time.

(b) *Operation as a public charity.* * * *

(3) *Notification of termination.* In order to comply with the requirements under section 507(b)(1)(B)(ii), an organization shall before the commencement of the 12-month or 60-month period under section 507(b)(1)(B)(i) (or before March 29, 1973) or, in the case of the 12-month period for a community trust, before May 11, 1977, notify the district director of its intention to terminate its private foundation status.

* * * * *

Par. 3. Section 1.508-3 is amended by revising paragraph (g)(3) to read as follows:

§ 1.508-3 Governing instruments.

* * * * *

(g) *Extension of time for compliance with section 508(e).* * * *

(3) For purposes of this paragraph the term "transitional dates" means the earlier of the following dates:

(i) In the case of a medical research organization, May 21, 1976 or in the case of a community trust February 10, 1977, or

(ii) The 91st day after the date an organization receives a final ruling or determination letter that it is a private foundation under section 509(a).

Par. 5. Temporary Treasury Regulations under the Tax Reform Act of 1969 [1969-3 C.B. 10] (26 CFR Part 13) are amended by revoking § 13.15.

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved:

WILLIAM M. GOLDSTEIN,
Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 11, 1976; 5:10 p.m., and published in the issue of the Federal Register for November 17, 1976, 41 F.R. 50649)

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26 CFR 1.170A-10: Charitable contributions carryovers of individuals.

Charitable contributions carryover; allocation between spouses. The amount of a contribution that exceeds the amount deductible on a joint return may not be allocated by agreement between the spouses in the carryover years for which they do not file a joint return, but must be allocated as provided in section 1.170A-10 of the regulations.

Rev. Rul. 76-267

Advice has been requested whether the amount of a charitable contribution that exceeds the amount deductible on a joint Federal income tax return may be allocated by agreement between the spouses in the carryover

years for which they do not file a joint return.

Section 170 of the Internal Revenue Code of 1954, provides, subject to certain limitations, a deduction for gifts and contribution to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

Section 1.170A-10(d)(4)(i) of the Income Tax Regulations provides, in part, that, if spouses make a joint return for a contribution year and compute an excess charitable contribution for such year in accordance with the provisions of the Code and regulations and if they make separate returns for one or more of the five succeeding taxable years immediately succeeding such contribution year, any excess charitable contribution for the contribution year that is unused at the beginning of the first taxable year for which separate returns are filed is to be allocated between the spouses. For purposes of the allocation, a computation must be made of the amount of any excess charitable contribution that each spouse would have computed in accordance with the Code and regulations if separate returns, rather than a joint return, had been filed for the contribution year. The portion of the total unused excess charitable contribution for the contribution year that is allocated to each spouse is the amount that bears the same ratio to the unused excess charitable contribution as such spouse's excess contribution, based on the separate return computation, bears to the total excess contributions of both spouses, based on the separate return computation.

The filing of a joint return by married taxpayers does not convert the charitable contribution deduction of one into the joint charitable contribution of both. Accordingly, married taxpayers must use the method of allocation provided in section 1.170A-10(d)(4)(i) of the regulations and may not allocate by agreement an excess charitable contribution deduction in the carryover years for which they do not file a joint return.

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26 CFR 1.170A-12: Valuation of a remainder interest in real property for contributions made after July 31, 1969.

Value of charitable remainder interest in depreciable and depletable real property, contributed after July 31, 1969, for gift tax purposes. See Rev. Rul. 76-473, page 306.

Section 172.—Net Operating Loss Deduction

26 CFR 1.172-1: Net operating loss deduction.

Ct. D. 1982

SUPREME COURT OF THE UNITED STATES

No. 74-799

United States, Petitioner, v. Foster Lumber Company, Inc.

[429 U.S. 32]

On writ of Certiorari to United States Court of Appeals for the Eighth Circuit.

[November 2, 1976]

Syllabus

Section 172 of the Internal Revenue Code of 1954, as amended, provides that a "net operating loss" experienced by a corporate taxpayer in one year may be carried as a deduction to the preceding three years and the succeeding five years to offset taxable income of those years. The entire loss must be carried back to the earliest possible year and any of the loss not "absorbed" by that first year may then be carried to succeeding years, since "[t]he portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried." § 172(b)(2). Proceeding under that provision respondent taxpayer carried back a net operating loss of some $42,000, which it had sustained in 1968, to 1966, in which year respondent had ordinary income of about $7,000 and a capital gain of about $167,000. After applying the "alternative tax" method of § 1201(a), which permits low capital gains taxation, respondent maintained that after subtracting the $42,000 loss deduction from the 1966 ordinary income, the negative balance of about $35,000 was still available to offset income for 1967, respondent taking the position that its 1968 loss had been "absorbed" in 1966 only to the extent of the $7,000 ordinary income. Respondent accordingly made a refund claim for the taxable year 1967, which the Commissioner disallowed but which the District Court upheld. The Court of Appeals affirmed. *Held:* In carrying back a net operating loss under § 172 to a year in which the taxpayer had both ordinary income and capital gains and employed the alternative tax computation method of § 1201(a), the loss deduction available for carryover to a succeeding year is the amount by which the loss exceeds the taxpayer's "taxable income"—ordinary income plus capital gains for the prior year—the loss carryover being "absorbed" by capital gains as well as ordinary income. Pp. 3-15.

(a) Absent any specific provision in the Code excluding capital gains from "taxable income," the Code's definitions of "taxable income" and gross income in §§ 63(a) and 61(a) require that both capital gain ordinary income must be included in the taxable income that § 172 directs must be offset by the loss deduction before any loss excess can be found available for transfer forward to the succeeding taxable year, and if Congress had intended to permit a loss deduction to offset only ordinary income when § 1201(a) is used, it could easily have said so. Pp. 3-9.

(b) The legislative history of the loss offset provisions does not support respondent's contention that they were designed to eliminate all consequences of the timing of the loss. Pp. 10-13.

(c) Had Congress intended substantially to eliminate timing accidents from the calculation of income on an average basis it would not have tolerated the departure from that purpose in § 172(c), under which a taxpayer cannot have a loss for a particular year unless its deductions exceed its ordinary income and its capital gains. Pp. 13-14.

500 F. 2d 1230, reversed.

STEWART J., delivered the opinion of the Court, in which WHITE, MARSHALL, REHNQUIST, and STEVENS, JJ., joined. STEVENS, J., filed a concurring opinion. BLACKMUN, J., filed a dissenting opinion, in which BURGER, C. J., and BRENNAN and POWELL, JJ., joined.

MR. JUSTICE STEWART delivered the opinion of the Court.

Section 172 of the Internal Revenue Code of 1954, as amended, provides that a "net operating loss" experienced by a corporate taxpayer in one year may be carried as a deduction to the preceding three years and the succeeding five years to offset taxable income

of those years.[1] The entire loss must be carried to the earliest possible year; any of the loss that is not "absorbed" by that first year may then be carried in turn to succeeding years. The respondent, Foster Lumber Co., sustained a net operating loss of some $42,000 in 1968, which it carried back to 1966. In 1966 the respondent had had ordinary income of about $7,000 and a capital gain of about $167,000. The question presented is whether a loss carryover is "absorbed" by capital gain as well as ordinary income or is instead limited to offsetting only ordinary income. The taxpayer filed a refund suit in a federal district court challenging the Commissioner's disallowance of its claim that the $35,000 of the 1968 loss not used to offset its 1966 ordinary income survived to reduce its 1967 tax liability. The trial court and the Court of Appeals for the Eighth Circuit agreed with the taxpayer. We granted certiorari to resolve a circuit conflict on a recurring question of statutory interpretation.[2]

I

The dispute in this case centers on the meaning of "taxable income" as used in § 172(b)(2) to govern the amount of carrybacks and carryovers that can be successfully transferred from one taxable year to another. In relevant part, § 172(b)(2) requires the net operating loss to be carried in full to the earliest taxable year possible, and provides that: "The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried." Thus when the loss has been carried back to the first year to which it is applicable, the loss "survives" for carryover to a succeeding taxable year only to the extent that it exceeds the taxable income of the earlier year. "Taxable income" is defined in § 63(a) of the Code to mean "gross income, minus the deductions allowed by this chapter." Gross income is in turn defined by § 61(a) of the Code as "all income from whatever source derived," and specifically includes "gains derived from dealings in property." On its face the concept of "taxable income" thus includes capital gains as well as ordinary income. In the absence of a specific provision ex-

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[1] "Sec. 172. Net operating loss deduction.

"(a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term 'net operating loss deduction' means the deduction allowed by this subsection.

"(b)[as amended by Sec. 317(b), Trade Expansion Act of 1962, P. L. 87-794, 76 Stat. 889 [1962-3 C.B. 107], and Secs. 210(a) and 210(b), Revenue Act of 1964, P. L. 88-272, 78 Stat. 47-49 [1964-1 (Part 2) C.B. 6]] *Net Operating Loss Carrybacks and Carryovers.*—

"(1) *Years to which loss may be carried.*—

"(A)(i) Except as provided in clause (ii) and in subparagraph (D), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

"(ii) In the case of a taxpayer with respect to a taxable year ending on or after December 31, 1962, for which a certification has been issued under section 317 of the Trade Expansion Act of 1962, a net operating loss for such taxable year shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.

"(B) Except as provided in subparagraphs (C) and (D), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

* * * * *

"(2) *Amount of carrybacks and carryovers.*—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

"(A) with the modifications specified in subsection (d) other than paragraphs (1), (4) and (6) thereof; and

"(B) by determining the amount of the net operating loss deduction—

"(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

"(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D), be carried back to such prior taxable year,

"and the taxable income so computed shall not be considered to be less than zero. For purposes of this paragraph, if a portion of the net operating loss for the loss year is attributable to a foreign expropriation loss to which paragraph (1)(D) applies, such portion shall be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss.

* * * * *

"(c) *Net Operating Loss Defined.*—For purposes of this section, the term 'net operating loss' means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

"(d) *Modifications.*—The modifications referred to in this section are as follows:

"(1) *Net operating loss deduction.*—No net operating loss deduction shall be allowed.

"(2) *Capital gains and losses of taxpayers other than corporations.*—In the case of a taxpayer other than a corporation—

* * * * *

"(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed."

[2] 420 U.S. 1003. In the present case the Court of Appeals for the Eighth Circuit followed the seminal Tax Court decision in *Chartier Real Estate Co.*, 52 T. C. 346, aff'd *per curiam*, 428 F. 2d 474 (CA1). See *Foster Lumber Co.* v. *United States*, 500 F. 2d 1230. The Ninth Circuit is in agreement with the First and the Eighth Circuits. See *Olympic Foundry Co.* v. *United States*, 493 F. 2d 1247, and *Data Products Corp.* v. *United States* (unpublished opinion, 1974), cert. pending, No. 74-996. The Fourth Circuit refused to follow the reasoning of those circuits in *Mutual Assurance Society* v. *Commissioner*, 505 F. 2d 128. The Sixth Circuit appears to agree in principle with the Fourth Circuit's reasoning. See *Axelrod* v. *Commissioner*, 507 F. 2d 884.

cluding capital gains,[3] it thus appears that both capital gain and ordinary income must be included in the taxable income that § 172 directs must be offset by the loss deduction before any loss excess can be found to be available for transfer forward to the succeeding taxable year.

The respondent argues that the Code's prescribed method for calculating the taxes due on its taxable income conflicts with this natural reading of § 172. The Code provides two methods for computing taxes due on corporate income, and a corporation is under a statutory duty to employ the method that results in the lower tax. 26 U.S.C. § 1201(a). Under § 11, the "regular method," ordinary income and capital gains income are added together to produce taxable income: during the period at issue a 22% tax rate was then imposed on the first $25,000 of taxable income and the remainder was taxed at a 48% rate. Section 1201(a) of the Code prescribes the "alternative tax," calculated in two steps and applied when resulting in a lower tax liability for the corporation. The first step computes a partial tax on the taxable income reduced by the net long-term capital gain[4] at the regular corporate rates imposed by § 11. This step effectively subjects only ordinary income to the partial tax. The second step imposes a 25% tax on the net long-term capital gain. The alternative tax is the sum of the partial tax and the tax on capital gain. In practical terms, the alternative tax does not redefine taxable income, but it does result in a much lower effective tax rate for corporations whose income is in whole or substantial part comprised of capital gain. It thus extends to corporations the long-standing statutory policy of taxing income from capital gain at a lower rate than that applicable to ordinary income.

The problem from the respondent's point of view is that the mechanics of the alternative tax work in such a way that the potential benefit of the loss deduction may not be fully reflected in reduced tax liability for the taxable year to which the loss is carried. The problem arises when, as in 1966 for the respondent, the "alternative method" governs the calculation of tax liability, and the ordinary income effectively subject to the partial tax under the first step is less than the loss deduction subtracted from it. The Code does not permit the excess loss to be subtracted from the capital gain income before the second step is carried out.[5] Under the alternative method, therefore, the tax benefit of the loss deduction is effectively lost for the carryover year to the extent that it exceeds the ordinary income in that year. This can be seen simply by considering the taxpayer's circumstances in this case. Subtracting the loss deduction of $42,203.12 from the 1966 ordinary income of $7,236.05 under Step 1[6] resulted in a negative balance of $34,967.07; no partial tax was imposed and the 25% rate on the $166,634.81 of capital gains under Step 2 produced a tax of $41,658.70. If the loss deduction had been merely $7,236.05, and thus exactly offset the $7,236.05 of ordinary income, however, the tax due would still have been $41,658.70. The taxpayer therefore asserts that only $7,236.05 of the loss deduction was actually "used" in 1966 and that $34,967.07 remained to be carried forward to reduce his tax liability in 1967.

There can be no doubt that if the "regular method" had been applicable to the respondent's taxes in 1966, the loss deduction ($41,658.70) would have been fully "used" to offset capital gains ($166,634.81) as well as ordinary income ($7,236.05), leaving $131,667.74 to be taxed, and a tax bill of $58,200.52.[7] It is clear that the

[3] Congress has specifically tailored definitions of taxable income in other sections of the Code when the § 63(a) definition is inadequate for its purposes. See, *e.g.*, I. R. C. § 593(b)(2)(E) (mutual savings banks); I. R. C. § 832(a) (insurance companies); I. R. C. § 852(b)(2) (regulated investment companies). Congress in fact did state certain modifications to the term "taxable income" in the third sentence of § 172(b)(2), but none of these modifications suggests any instances in which taxable income does not include capital gains.

[4] For purposes of simplicity we use the term "net long-term capital gain" or simply "capital gain" rather than the statutory phrase "excess of net long-term capital gain over net short-term capital loss." Similarly, we use the term "loss deduction" rather than the statutory phrase "net operating loss deduction."

[5] See I. R. C. § 1201(a)(2) and *Chartier Real Estate Co.*, 52 T. C. 346, 350-356, aff'd, 428 F. 2d 474; *Weil* v. *Commissioner*, 23 T. C. 424, aff'd, 229 F. 2d 593.

[6] The description in text of the alternative tax computation method is truncated; the mechanics are here set out in full:

"Alternative Method" (Section 1201)

Taxable Income (excluding net operating loss deduction):	
Ordinary Income	$7,236.05
Capital Gains Income	166,634.81
	$173,870.86
LESS: Net Operating Loss Deduction Resulting From Carryback of 1968 Net Operating Loss	(42,203.12)
Taxable Income (Section 63(a))	$131,667.74
(Step 1—Partial Tax)	
LESS: Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss	$166,634.81
Balance	($ 34,967.07)
Partial Tax at Section 11 Rates on Balance (Section 1201(a)(1))	-0-
(Step 2—Capital Gains Tax)	
PLUS: Capital Gains Tax at Flat 25 Percent Rate on Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss (Section 1201(a)(2))	$ 41,658.70
Alternative Tax (Sum of Partial Tax and Capital Gains Tax) (1966 rates)	$ 41,658.70

[7] The steps taken to reach that result are as follows:

"Regular Method" (Section 11)

Taxable Income (excluding net operating loss deduction):	
Ordinary Income	$7,236.05
Capital Gains Income	166,634.81
	$173,870.86

alternative tax produced the lower tax liability despite the inability to fully "use" the loss deduction; the lower tax resulted directly from the favorable rate of taxation of capital gain income prescribed by the alternative method. The question is whether the two "tax benefit" provisions relied on by the respondent—low capital gains taxation under the alternative method and the loss carryback provision—must each be maximized independently of the other or whether Congress instead anticipated that the benefit provided by the loss deduction might on occasion be subsumed in the greater benefit provided by the alternative tax computation method.

Section 172 does not explicitly address the question of fit between these two tax benefits, providing simply that "the portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried." The respondent contends, and the Tax Court in *Chartier Real Estate Co.* v. *Commissioner,* 52 T. C. 346, aff'd, *per curiam,* 428 F. 2d 474, held, that the phrase "to which such loss may be carried" modifies "taxable income" as well as "for each of the prior taxable years." The Tax Court in the *Chartier* case further held that " 'taxable income' in this context (as modified by the above phrase) means that taxable income to which the loss is actually applied in computing actual tax liability." 52 T. C., at 357-358. In other words, it was held, taxable income refers only to that ordinary income offset by a loss deduction that produces an additional reduction in tax liability under the alternative tax computation method.

LESS: Net Operating Loss Deduction Resulting From Carryback of 1968 Net Operating Loss	(42,203.12)
Taxable Income (Section 63(a))	$131,667.74
Regular Tax (1966 rates)	$ 58,200.52

It is, of course, not unusual in statutory construction to find that a defined term's meaning is substantially modified by an attached clause. But reading "taxable income to which such loss may be carried" as equivalent to "taxable income to which such loss may be carried and deducted resulting in a reduction of tax liability" gives these phrases a synergistic effect that goes well beyond a natural reading of their import. Such a construction subtly redefines "taxable income" in terms of the tax impact of a particular method of tax calculation. It thus implicitly departs from the "term of art" definition of taxable income given in § 63 (a), while discovering a significance in the word "carry" that goes well beyond its usual connotation of a transfer of a loss from the year in which it occurred. Standing alone, this strained reading of the statute's terms falls considerably short of the explicit statutory support the Court has previously required of taxpayers seeking a tax benefit from losses suffered in other years. See, *e.g., Woolford Realty Co.* v. *Rose,* 286 U.S. 319, 326 [XI-1 C.B. 154].[8] If Congress had intended to allow a loss deduction to offset only ordinary income when the alternative tax calculation method is used, it could easily have said so.

II

The respondent further asserts that the legislative history and the broad policy behind the loss deduction section of the Code supports its interpretation of "taxable income" under § 172(b). Although, for the reasons stated above, it can hardly be said that the benefit claimed by the respondent is fairly within the statutory language, it is not inappropriate to consider this contention—to consider, in short, whether "the construction sought is in harmony with the statute as an organic whole." See *United States* v. *Olympic Radio & Television,* 349 U.S. 232, 240 [1955-1 C.B. 376].

The respondent relies on the Court's opinion in *Lisbon Shops* v. *Koehler,* 353 U.S. 382, 386 [1952-2 C.B. 891], for a description of the legislative purpose in allowing loss carryovers. In that case the Court said that the net operating loss carryover and carryback provisions "were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year."

There were, in fact, several policy considerations behind the decision to allow averaging of income over a number of years. Ameliorating the timing consequences of the annual accounting period makes it possible for shareholders in companies with fluctuating as opposed to stable incomes to receive more nearly equal tax treatment. Without loss offsets, a firm experiencing losses in some periods would not be able to deduct all the expenses of earning income. The consequence would be a tax on capital, borne by shareholders who would pay higher taxes on net income than owners of businesses with stable income.[9] Congress also sought through allowance of loss carryovers to stimulate enterprise and investment, particularly in new businesses or risky ventures where early losses can be carried forward to future more prosperous years.[10]

[8] The construction urged by the respondent also finds no support in the Treasury Regulations on Income Tax that implement § 172. See 26 CFR §§ 1.172-4, 1.172-5.

[9] See generally U.S. Treasury Department and Joint Committee on Internal Revenue Taxation, Business Loss Offsets (1947), excerpted in Bittker and Stone, Federal Income Estate and Gift Taxation (1972), at 859-863.

[10] See, *e.g.,* H.R. Rep. No. 855, 76th Cong., 1st Sess., 9 (1939):

"New enterprises and the capital-goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carry-over will greatly aid business and stimulate new enterprises."

The respondent focuses on the equalizing purposes of § 172 to argue that the Commissioner's insistence on the absorption of the loss carryover by capital gain income is inconsistent with § 172's primary purpose of avoiding the subjection of similarly situated taxpayers to significantly different treatment solely on the basis of arbitrary timing. This argument is based on the observation that, unless it is accepted, the taxpayer's ability to fully benefit from the net loss carryover deduction will turn on whether ordinary income in the first year to which the loss may be carried exceeds or is less than the loss deduction. If the ordinary income exceeds the loss, the taxpayer will get the full benefit of the deduction; if the ordinary income is less than the loss, the shortfall will be absorbed by capital gain income without providing an incremental tax reduction.

Congress may, of course, be lavish or miserly in remedying perceived inequities in the tax structure. While there is no doubt that Congress through the loss carryover provisions did intend to reduce the arbitrariness inherent in a taxing system based on annual accounting, the history of the loss offset provision does not support the respondent's vision of a Congress seeking perfection in the realization of its objective.[11]

Over the years, Congress has shifted the definition of both the kinds of losses and the kinds of income that may be used in calculating the loss offset, indicating its ability in this area of the Internal Revenue Code as in others to make precise definitions and later to modify them in pursuing its broad policy goals.[12] For example, Congress in 1924 specifically provided that a noncorporate taxpayer could use the excess of a loss deduction over ordinary income to reduce the amount of capital gain subject to tax,[13] thus permitting full "use" of the loss deduction by the taxpayer. The inference can be drawn that Congress was aware of the potential "waste" of the deduction otherwise and acted to prevent it. That provision was in turn left out of the 1939 Code, leading to the contrary inference that Congress was aware of the "waste" of the deduction but decided not to remedy it.

The 1939 revision of the Code, in fact, tolerated even further "waste" of the loss deduction, providing not only that the loss must be offset against net income (ordinary income and capital gains),[14] but that tax-exempt interest income must also be included in income that the loss was required to offset. This provision had the same arbitrary policy consequences that the respondent decries under the alternative tax computation method applicable here. It required the loss deduction to be "used up" in offsetting tax-exempt income, thus "wasting" a portion of the loss deduction's capacity to reduce overall tax liability. And it made the utility of the loss deduction turn on the accidents of timing. The loss deduction would be "wasted" in offsetting tax-exempt income realized in an early year, while if the tax-exempt income were not realized until a later year the full tax benefit of the loss deduction could have been garnered. Such results cut against any assertion that the loss deduction provisions have consistently been used completely to minimize arbitrary timing consequences, and indicate that Congress has not hesitated in this area to limit taxpayers to the enjoyment of one tax benefit even though it could have made them eligible for two.

The 1954 Internal Revenue Code continued the 1939 Code's definition of ordinary and capital gain income as subject to setoff by the § 172 loss deduction. Although several substantive changes in the net operating loss offset section were made and commented on in the legislative reports

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See also H.R. Rep. No. 1337, 83d Cong., 2d Sess., 27 (1954): "The longer period for averaging will improve the equity of the tax system as between businesses with fluctuating income and those with comparatively stable incomes, and will be particularly helpful to the riskier types of enterprises which encounter marked variations in profitability."

[11] Since 1918, the carryover period has gradually been lengthened to provide more potential years of positive income against which experienced losses can be offset; a perfect system from a taxpayer's point of view, however, would eschew any time limitations altogether.

[12] Section 204(b) of the Revenue Act of 1918 was the first provision to permit the excess of expenses over income in one tax year to be deducted in another tax year. A one-year carryover and carryback was allowed. See Act of Feb. 24, 1919, c. 18, § 204, 40 Stat. 1060. In 1933, the National Industrial Recovery Act abolished all net operating loss carryovers and carrybacks. See Act of June 16, 1933, c. 90, § 218(a), 48 Stat. 209. In 1939, a net operating loss carryover provision was reintroduced and provided for a two-year carryover. See Act of June 29, 1939, c. 247, § 122, 53 Stat. 867. The three-year carryback and five-year carryover permitted since 1958, has recently been amended to allow seven years for carryover and to permit the taxpayer to elect to forego carrybacks and to instead carry the net operating loss forward seven years. See Tax Reform Act of 1976, Pub. L. No. 94-455 [1976-3 C.B.], § 806 (Oct. 4, 1976).

[13] Act of June 2, 1924, c. 234, § 208(a)(5), 43 Stat. 262.

[14] Counsel for the respondent relied in oral argument on *Merrill* v. *United States*, 105 F. Supp. 379 (Ct. Cl.), which excluded capital gains from the term "net income" in interpreting the 1939 Code's § 12(g) limitation on tax liability, to demonstrate that "net income" under the 1939 Code could for policy reasons be construed to avoid the unnecessary "wasting" of a loss. Such a construction would be in direct conflict with the statute's general definition of "net income"; under § 122 of the 1939 Code governing loss deductions, there was no phrase like "to which such loss may be carried" to give even a colorable statutory construction basis to its argument that net income does not include capital gains. The *Merrill* case obviously does not control construction of the "net income" term as used in § 122 of the 1939 Code. And it would be anomalous in any case to conclude that Congress meant to exclude capital gain income from offsetting a loss deduction with the purpose of avoiding "wasting" a loss deduction, when Congress simultaneously required "waste" of the loss deduction by providing that it must offset tax-exempt interest and depletion income as well as net income. See Internal Revenue Code of 1939, § 122(d)(1), (2).

accompanying the Code,[15] there was no indication that the addition to § 172(b) of the phrase "to which such loss may be carried" was meant to signal a willingness to condition the loss deduction's life on its ability to produce full tax benefits for the taxpayer. In view of the predecessor statutes' tolerance of a taxpayer inability to maximize the tax benefit of a loss deduction, and the complete failure of the Committee Reports in any way to indicate the shift in policy the respondent claims to discern in the 1954 Code revision, the legislative history simply does not support the respondent's contention that the addition in 1954 of the phrase "to which such loss may be carried" was intended to eliminate the requirement that the loss deduction be used to offset capital gain under the alternative tax computation method.

We turn finally to an examination of § 172(b) in the context of the statute as it exists today. If the statute could be viewed as consistently minimizing the arbitrariness of timing consequences, a construction of § 172 (b) inconsistent with that approach might be suspect. Section 172 as a whole has not, however, been drafted with the singleminded devotion to reducing arbitrary timing consequences that the respondent urges should control the decision in this case.

The most telling example of Congress' failure to remedy all timing accidents that "rob" a taxpayer of the full benefit of the loss deduction can be found in § 172(c). That provision defines a "net operating loss" as "the excess of the deductions allowed by this chapter over the gross income." A taxpayer does not have a loss for a particular year unless its deductions exceed its ordinary income and its capital gains. When an ordinary income loss is experienced in a year of negligible capital gains it gives rise to a net operating loss that can be carried over to other years. If that same ordinary income loss comes in a year when the net capital gains exceed that loss, there is no net operating loss under the statute to carry to another year. Because the statute also forbids setting off that ordinary loss against the capital gains before the capital gains tax is computed under the alternative method,[16] the loss' potential tax benefit is arbitrarily "lost" to the taxpayer solely as a result of accidents of timing. Congress, of course, can and occasionally has in the past treated loss years differently from carryover years. But if Congress were intent on substantially eliminating accidents of timing from the calculation of income on an average basis, it would hardly have tolerated such a departure from that purpose at the very inception of the tax benefit provided by § 172.

The respondent's argument is further undercut by the holding in *Chartier Real Estate Co., supra,* not challenged here,[17] that the staute forbids using a loss deduction to offset capital gains income in a loss carryover year. If such an offset were permitted, the taxpayer would benefit by a further reduction in its capital gains tax liability already calculated at a preferential rate. The respondent in effect asks this Court to infer from that deliberate denial of the limited tax benefit that would accrue from using the loss to offset preferentially taxed capital gains, that Congress implicitly meant to confer the even greater tax benefit of using the loss to offset ordinary income taxed at the higher regular rates. In a statutory section that part by part manages explicitly to detail loss calculations on one hand and deductions on the other,[18] such a leap in statutory construction must be much more firmly grounded in a consistently articulated and achieved congressional purpose than can be discerned here.

The respondent's broad argument, in short, boils down to a contention that "harmony with the statute as an organic whole" can be achieved in this area only by reading the Code provision so as to give the greatest possible benefits to all taxpayers. For the reasons we have discussed, that is a contention that cannot be accepted.

The judgment is

Reversed.

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[15] See H.R. Rep. No. 1337, 83d Cong., 2d Sess., 27 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 31-33 (1954), H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess., 30 (1954).

[16] See *Chartier Real Estate Co., supra.*

[17] The *Chartier* holding relied on *Weil* v. *Commissioner, supra,* a case in which the Tax Court had concluded that the express language of the 1938 Act provided for a flat rate of tax on taxable capital gain, unreduced by a loss deduction, as an alternative to the tax imposed upon such gain when it is included in gross income and taxed in the regular manner. An *Amicus Curiae* brief filed in the present case urges that this holding be reconsidered on policy grounds should the respondent's argument be rejected, but concedes that the language of § 1201(a)(2) supports the result reached in *Weil* and applied in *Chartier.*

[18] Section 172(d)(2)(B) provides a further indication that capital gains are properly included in the taxable income that a loss deduction must offset before being carried to a succeeding carryover year. For a noncorporate taxpayer who normally computes his tax liability by deducting 50% of net long-term capital gains under § 1202 of the Code, § 172(d)(2)(B) requires that the full amount of ordinary income plus capital gains be offset against the net operating loss. That "taxable income" encompasses capital gains income for individual taxpayers under § 172 strongly suggests that the "taxable income" of corporate taxpayers should be given similar scope.

Section 174.—Research and Experimental Expenditures

26 CFR 1.174-4: Treatment as deferred expenses.
(Also Sections 266, 7805; 1.266-1, 301.7805-1.)

Election to defer research and experimental expenditures. For taxable years ending after August 29, 1976, the claim on a tax return of a deduction for a portion of research and experimental expenses incurred, without a written election statement, will not be treated as an election to defer and amortize such expenses; Rev. Rul. 71-136 revoked.

Rev. Rul. 76-324

The Internal Revenue Service has been asked to reconsider the position set forth in Rev. Rul. 71-136, 1971-1 C.B. 97, relating to the proper method of electing to defer and amortize research and experimental expenditures under section 174 of the Internal Revenue Code of 1954.

The facts in Rev. Rul. 71-136 concern a taxpayer, a domestic corporation, that expended 20*x* dollars for research and experimental expenditures in connection with product *X* during the taxable year ended December 31, 1964, its first year of operation. The taxpayer's books and financial statements for 1964 reflected a deduction of one-fifth of the amount so expended as amortization for the year. A deduction of one-fifth of the amount expended was claimed as a deduction on the taxpayer's Federal income tax return for 1964 and each of the 4 succeeding years. The return for 1964 did not contain a written statement in the form required by section 1.174-4 (b)(1) of the Income Tax Regulations regarding an election to amortize the expenditures.

During the taxable year ended December 31, 1968, the taxpayer expended 30*x* dollars for research and experimental expenses in connection with new product *Y*. Such amount was deferred by the taxpayer on its books and one-fifth of that amount was amortized and claimed as a deduction on the taxpayer's Federal income tax return for 1968.

In 1969 the taxpayer expended an additional 10*x* dollars for research and experimental expenditures in connection with product *Y*. Part of such expenditure was expensed and part was deferred by the taxpayer for Federal income tax purposes in 1969.

The taxpayer did not request permission to change its method of treatment of research and experimental expenditures for 1968 with respect to new product *Y*.

The questions presented in Rev. Rul. 71-136 were whether a valid election to defer research and experimental expenses was made by the taxpayer in 1964, pursuant to section 1.174-4 of the regulations, and whether section 174 of the Code was properly applied in 1968 and 1969 with respect to the research and experimental expenditures made in 1968 and 1969.

Section 174(a) of the Code provides, in part, that a taxpayer may treat research or experimental expenditures that are paid or incurred by the taxpayer during the taxable year in connection with the taxpayer's trade or business as expenses that are not chargeable to the taxpayer's capital account. The expenditures so treated shall be allowed as a deduction. Section 174(b) provides, in general, that a taxpayer may, under certain circumstances, elect to treat such expenditures as deferred expenses.

Section 1.174-1 of the regulations provides, in part, that research or experimental expenditures paid or incurred by the taxpayer in connection with the taxpayer's trade or business may be treated as expenses not chargeable to capital account and deducted in the year in which they are paid or incurred (section 1.174-3), or they may be deferred and amortized (section 1.174-4). Research or experimental expenditures that are neither treated as expenses nor deferred and amortized under section 174 of the Code must be charged to capital account.

Section 1.174-3(a) of the regulations provides, in part, that research or experimental expenditures paid or incurred by a taxpayer during the taxable year in connection with the taxpayer's trade or business are deductible as expenses, and are not chargeable to capital account, if the taxpayer adopts the method provided in section 174 (a) of the Code. If adopted, the method shall apply to all research and experimental expenditures paid or incurred in the taxable year of adoption and all subsequent taxable years, unless a different method is authorized by the Commissioner of Internal Revenue under section 174(a)(3) with respect to part or all of the expenditures.

Section 1.174-3(b)(1) of the regulations provides, in part, that the consent of the Commissioner is not required to treat the research and experimental expenditures as expenses if the taxpayer adopts such method for the first taxable year in which the taxpayer pays or incurs research or experimental expenditures. The taxpayer may do so by claiming in the taxpayer's income tax return for such taxable year a deduction for such research or experimental expenditures. If the taxpayer fails to adopt the method for the first taxable year in which the taxpayer incurs such expenditures, the taxpayer cannot do so in subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner under section 174(a)(2)(B) of the Code and section 1.174-3(b)(2).

Section 1.174-4(a)(1) of the regulations provides, in part, that if a taxpayer has not adopted the method provided in section 174(a) of the Code of treating research or experimental expenditures paid or incurred by the taxpayer in connection with the taxpayer's trade or business as currently deductible expenses, the taxpayer may elect to treat such expenditures as deferred expenses under section 174(b).

Section 1.174-4(a)(5) of the regulations provides, in part, that the election shall apply for the taxable year for which the election is made and for all subsequent taxable years, unless a change to a different treatment is authorized by the Commissioner under section 174(b)(2) of the Code. That regulation section further provides that in no event will the taxpayer be permitted to treat part of the expenditures with respect to a particular project as deferred expenses under section 174(b) and to adopt a different method of treating the balance of the

expenditures relating to the same project for the same taxable year.

Section 1.174-4(b)(1) of the regulations provides, in part, that the election under section 174(b) of the Code shall be made by attaching a statement to the taxpayer's return for the first taxable year to which the election is applicable. That section further provides that the statement shall be signed by the taxpayer and shall contain six enumerated items of information.

Section 1.174-4(b)(2) of the regulations provides, in part, that application for permission to change to a different method of treating research or experimental expenditures or to a different period of amortization for deferred expenses shall be in writing and shall be addressed to the Commissioner.

Section 266 of the Code provides that no deduction shall be allowed for amounts paid or accrued for such taxes and carrying charges as, under regulations prescribed by the Secretary or the Secretary's delegate, are chargeable to capital account with respect to property, if the taxpayer elects, in accordance with such regulations, to treat such taxes or charges as so chargeable.

Section 1.266-1(c)(3) of the regulations provides, in part, that if the taxpayer elects to capitalize an item or items under section 1.266-1, such election shall be exercised by filing with the original return for the year for which the election is made a statement indicating the item or items that the taxpayer elects to treat as chargeable to a capital account.

In *Kentucky Utilities Co. v. Glenn,* 394 F.2d 631 (6th Cir. 1968), one of the issues involved was whether the taxpayers had elected to capitalize social security taxes paid on construction work under section 24(a)(7) of the Internal Revenue Code of 1939 (the predecessor of section 266 of the 1954 Code). The taxpayers had treated the social security taxes in their Federal income tax returns for the years involved therein as if they had elected to capitalize such taxes. The taxpayers attached a detailed schedule to their returns that clearly indicated those items that the taxpayers were capitalizing. However, no formal statement electing to capitalize the taxes was filed by the taxpayers. The taxpayers subsequently amended their returns and filed statements claiming deductions for such taxes. The court held that the taxpayers had made a binding election with their original returns that could not be retroactively changed.

In the situation described in Rev. Rul. 71-136, the taxpayer did not file a written statement with its Federal income tax return for the year 1964, electing to treat the research and experimental expenses as deferred expenses under section 174(b) of the Code, as required by section 1.174-4(b)(1) of the regulations. However, the taxpayer, in its 1964 return, did treat such expenditures as if it had elected to defer such expenses by deducting only one-fifth of the amount expended.

Rev. Rul. 71-136, relying upon *Kentucky Utilities Co.,* held that, although the taxpayer did not file the formal statement required by section 1.174-4(b)(1) of the regulations with its Federal income tax return for 1964, the taxpayer made a sufficient election to defer its research and experimental expenditures under section 174(b) of the Code by treating such expenditures on its Federal income tax return as if it had elected to defer such expenditures by deducting only one-fifth of the amount expended.

However, the facts in *Kentucky Utilities Co.* are distinguishable from the facts in Rev. Rul. 71-136. In *Kentucky Utilities Co.,* the taxpayers, although they did not file a formal statement electing to capitalize the taxes involved therein under section 266 of the Code, did attach a detailed schedule to their returns that clearly indicated those items that the taxpayers were capitalizing. Such treatment is consistent with section 1.266-1(c)(3) of the regulations, which requires "a statement indicating the item or items . . . which the taxpayer elects to treat as chargeable to capital account." In Rev. Rul. 71-136, the taxpayer did not attach a schedule or other information that clearly indicated the items it was electing to defer and amortize. Thus, the taxpayer failed to clearly communicate its intention to defer and amortize the expenditures in question.

In addition, sections 1.266-1(c)(3) and 1.174-4(b)(1) of the regulations contain distinctly different requirements for elections made under section 266 and section 174(b) of the Code, respectively. Section 1.174-4(b)(1) requires greater formality and more specific information than section 1.266-1(c)(3). The taxpayer in Rev. Rul. 71-136 did not attach a statement that contained the six enumerated items of information required by section 1.174-4(b)(1).

Accordingly, in Rev. Rul. 71-136, the taxpayer's treatment of its research and experimental expenditures on its 1964 Federal income tax return was not a valid election to defer and amortize such expenditures under section 174(b) of the Code and section 1.174-4(b)(1) of the regulations. In addition, since the taxpayer did not make a valid election in 1964 to defer and amortize its research and experimental expenditures, section 174 of the Code was not properly applied in 1968 and 1969 with respect to the research and experimental expenditures made in 1968 and 1969. Therefore, inasmuch as the taxpayer did not make a valid election under section 174(b) and did not adopt a method provided in section 174(a), its research and experimental expenditures incurred in the above years must be capitalized.

Rev. Rul. 71-136 is revoked.

Pursuant to the authority contained in section 7805(b) of the Code, this Revenue Ruling will not be applied

to taxable years ending before August 30, 1976, the date of publication of this Revenue Ruling in the Internal Revenue Bulletin.

Section 183.—Activities Not Engaged In for Profit

26 CFR 1.183-1: Activities not engaged in for profit.
(Also Sections 162, 163, 164, 167, 262; 1.162-1, 1.163-1, 1.164-1, 1.167(a)-1, 1.262-1.)

Three-family dwelling unit rented to relative at less than fair rental value. The application of section 183 of the Code is illustrated with respect to allocation and allowance of deductions by the owner of a three-family dwelling, one unit being owner occupied, one unit being rented to a relative at less than fair rental value, and the remaining unit being rented at fair rental value.

Rev. Rul. 76-287

Advice has been requested under the circumstances described below, regarding the application of section 183 of the Internal Revenue Code of 1954 to the allowance of deductions for expenses incurred for the maintenance of a multiple family dwelling.

The owner of a three-family dwelling occupies one-third personally, rents one-third to a relative for $1,000 for the year, and rents the remaining one-third to an unrelated person for $2,400, which is the annual fair rental value for each of the units. The annual expenses for the entire dwelling are as follows: $900 interest, $1,500 real estate taxes, $1,200 maintenance and utilities, and $1,500 depreciation.

Section 262 of the Code provides that, except as expressly provided in chapter 1 of subtitle A, no deduction shall be allowed for personal, living, or family expenses.

Section 183 of the Code, which is the exclusive provision for allowing as deductions any expenses attributable to activities not engaged in for profit, provides that no deduction attributable to such activity will be allowed except: (1) the deduction allowable under chapter 1 of subtitle A for the taxable year without regard to whether such activity is engaged in for profit, and (2) a deduction equal to the amount of the deductions that would be allowable under chapter 1 of subtitle A for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable under (1) above.

Section 162(a) of the Code provides for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.183-1(d)(1) of the Income Tax Regulations provides, in part, that in order to determine whether, and to what extent, section 183 of the Code and the regulations thereunder apply, the activity or activities of the taxpayer must be ascertained. For instance, where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may be one activity. In ascertaining the activity, or activities of the taxpayer, all the facts and circumstances of the case must be taken into account.

Section 1.183-1(d)(2) of the regulations provides the rules for allocation of expenses if it is determined, after taking into account all the facts and circumstances, that section 183 of the Code and the regulations thereunder apply to a particular taxpayer's activities. This section of the regulations provides, in part, that where property is used in several activites, and one or more of such activities is determined not to be engaged in for profit, deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis.

Under the facts and circumstances in the instant case, the renting of the unit to a relative for less than fair rental value is one activity and the renting of the unit to an unrelated person for fair market value is a separate activity. The renting of the unit to the relative is an activity not engaged in for profit under section 183 of the Code. The renting of the unit to the unrelated person is a business activity. Thus, deductions must be allocated on a reasonable and consistently applied basis and may be made on a unit basis.

Under the particular facts and circumstances, allocation of the expenses and depreciation on a unit basis is as follows:

		Personal use 1/3 allocable to section 262	Business use 1/3 allocable to section 162	Activity not engaged in for profit 1/3 allocable to section 183
Interest	$ 900	$ 300	$ 300	$ 300
Real Estate Taxes	1500	500	500	500
Maintenance and Utilities	1200	400	400	400
Depreciation	1500	500	500	500
Total	$5100	$1700	$1700	$1700

Section 1.183-1(b)(1) of the regulations provides, generally, that if an activity is not engaged in for profit, deductions are allowable under section 183(b) of the Code in the following order and only to the following extent:

(1) amounts allowable as deductions during the taxable year without regard to whether the activity was engaged in for profit are allowable in full; (2) amounts that would otherwise be allowable if the activity were engaged in for profit that would not result in an adjustment to the basis of the property if allowed are allowed only to the extent the gross income derived from the activity exceeds the deductions allowed or allowable in (1); and (3) amounts that would otherwise be allowable if the activity were engaged in for profit that would result in an adjustment to the basis of the property if allowed are allowed only to the extent the gross income derived from the activity exceeds the deductions allowed or allowable in (1) and (2).

Thus, if the activity is not engaged in for profit, (A) interest and taxes are deductible in full because they would otherwise be allowable under sections 163 and 164 of the Code; (B) operating expenses are deductible to the extent that the gross income therefrom exceeds the interest and taxes, and (C) depreciation is deductible to the extent that gross income therefrom exceeds the interest, taxes, and operating expenses.

Section 62 of the Code sets forth those deductions to be subtracted from gross income in computing adjusted gross income in the case of an individual. In general, under section 62(1) the deductions allowed by chapter 1 of subtitle A of the Code that are attributable to a trade or business carried on by the taxpayer, except as an employee, are subtracted from gross income in computing adjusted gross income. Under section 62(5) the deductions allowed by section 183 that are attributable to property held for the production of rents are subtracted from gross income in computing adjusted gross income.

However, since deductions allowed under section 183 of the Code cannot be attributable to a trade or business, section 62(1) does not apply. Property is only held for the production of rents when the primary purpose in holding the property is to produce rental income in excess of the expenses attributable to the property. In other words, there must be a profit motive. Thus, if an activity is not engaged in for profit under section 183(c), then the property associated with such activity is not held for the production of rents within the meaning of section 62(5).

Therefore, any deductions allowable under section 183 of the Code are to be deducted from adjusted gross income in computing taxable income and may be taken only if the taxpayer itemizes deductions. Rev. Rul. 75-14, 1975-1 C.B. 90.

Accordingly, in the instant case, since one-third of the expenses and one-third of the depreciation are attributable to the activity not engaged in for profit, $300 of interest and $500 of real estate taxes (deductions that are specifically allowable under sections 163 and 164(a) of the Code), and $200 of maintenance and utilities (the difference between the $1,000 gross income from the activity and the $800 deduction for interest and taxes above) are allowable as deductions under section 183.

Further, the expenses and depreciation that are attributable to the personal occupancy by the owner of the dwelling are nondeductible personal, living, and family expenses under section 262 of the Code. However, amounts otherwise allowable as deductions during the taxable year under chapter 1 of subtitle A are allowable to the full extent allowable by the relevant Code sections. Accordingly, interest of $300 and real estate taxes of $500 are deductible under section 163 and section 164, respectively, if the taxpayer itemizes deductions.

Also, the expenses and depreciation ($1,700) that are attributable to the business use of the dwelling are deductible under sections 162 and 167 of the Code. These amounts are deductible from gross income in computing adjusted gross income.

Part VII.—Additional Itemized Deductions for Individuals

Section 212.—Expenses for Production of Income

26 CFR 1.212-1: Nontrade or nonbusiness expenses.

Treatment of trustees' fees paid by an estate to trustees of a grantor trust. See Rev. Rul. 76-498, page 199.

Section 213.—Medical, Dental, etc., Expenses

26 CFR 1.213-1: Medical, dental, etc., expenses.

Medical expense; face lifting. Plastic surgeon's fees paid for a "face lifting" operation, not the result of a recommendation of a physician, qualify as amounts paid for medical care under section 213 (e) of the Code.

Rev. Rul. 76-332

Advice has been requested whether, under the circumstances described below, expenditures made for plastic surgery are amounts paid for medical care as defined in section 213(e) of the Internal Revenue Code of 1954.

A taxpayer, who was not suffering from a mental disorder, paid surgeon fees in connection with plastic surgery that improved the taxpayer's personal appearance. The operation, commonly referred to as "face lifting," involved the elimination or removal of chin and neck sag, jowls, bags under the eyes, and excess tissue from under the eyelids. The operation was not the result of a recommendation by a physician.

The term "medical care" is defined in section 213(e)(1) of the Code as meaning amounts paid:

(A) for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body,

(B) for transportation primarily for and essential to medical care referred to in subparagraph (A), or

(C) for insurance * * * covering medical care referred to in subparagraphs (A) and (B).

Section 1.213-1(e)(1)(ii) of the Income Tax Regulations provides, in part, that amounts paid for operations or treatments affecting any portion of the body are deemed to be for the purpose of affecting any structure or function of the body and are therefore paid for medical care. Deductions for expenditures for medical care allowable under section 213 of the Code will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. Thus, payments for medical care include payments for hospital services, nursing services, medical, laboratory, surgical, dental and other diagnostic and healing services, X-rays, medicine, and drugs. However, an expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care.

Since the purpose of the taxpayer's operation was to affect a structure of the human body, its cost is an amount paid for medical care as defined in section 213(e) of the Code and section 1.213-1(e)(1)(ii) of the regulations. Therefore, the amount the taxpayer paid for the operation is deductible as a medical expense within the limitations of section 213.

See Rev. Rul. 73-201, 1973-1 C.B. 140, as clarified by Rev. Rul. 73-603, 1973-2 C.B. 76, which holds that a vasectomy, an abortion, or an operation to render the taxpayer incapable of having children, affects a function or structure of the body and the cost of such operation qualifies as medical care under section 213(e)(1) of the Code.

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26 CFR 1.213-1: Medical, dental, etc., expenses.
(Also Section 152; 1.152-4.)

Medical expenses; children of divorced parents; support payments deposited in special account. A divorced taxpayer, not having custody of the children of a former marriage but entitled to claim the children as dependents under section 151 of the Code, may deduct the medical expenses of the children paid by the taxpayer's former spouse from a special account established for the support money provided by the taxpayer for the children.

Rev. Rul. 76-344

Under a court decree, a divorced taxpayer's former spouse was granted custody of their children. The taxpayer was entitled to claim the children as dependents under section 151 of the Internal Revenue Code of 1954. The former spouse established a special account for the support money received for the children, and did not commingle the support money with any other funds. The spouse also maintained records substantiating the deposits to and the disbursements from the special support money account. The records substantiating the medical expense disbursements by the taxpayer's spouse were available to the taxpayer. During the taxable year the former spouse paid medical expenses on behalf of the children with funds from the support money account.

Section 213 of the Code allows a deduction for amounts, not compensated for by insurance or otherwise, paid during the taxable year for medical care of the taxpayer, the taxpayer's spouse and dependents, to the extent the amounts paid exceed three percent of the taxpayer's adjusted gross income. The expenditures for medical care must be "paid" by the taxpayer who claims a deduction for such expenditures. See *Robert W. Hodge*, 44 T.C. 186 (1965).

Held, in the instant case the amounts paid by the former spouse for the medical care of taxpayer's dependent children from the support money provided by the taxpayer are deductible by the taxpayer as medical expenses paid by the taxpayer under section 213 of the Code, subject to the limitations therein.

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26 CFR 1.213-1: Medical, dental, etc., expenses.

Medical expenses; retirement home fees. The portion of a founder's fee and monthly fee paid by individuals in connection with their life-care residence at a retirement home that is properly allocable to medical care is deductible as a medical expense in the year paid; however, the portion of the founder's fee used to construct the health facilities is not deductible. In the event the individuals choose to terminate residence, any refund of the founder's fee is includible in gross income to the extent attributable to deductions previously allowed under section 213 of the Code.

Rev. Rul. 76-481

Advice has been requested whether, under the circumstances described below, any portion of the founder's fee and the monthly fee paid by individuals in connection with their residence at a retirement home under a life-care contract is deductible by the individuals as an expense for medical care under section 213 of the Internal Revenue Code of 1954.

The taxpayers entered into an agreement with a retirement home under which they became entitled to live in the home and to receive lifetime care that includes specified residential accommodations, meals, and medical care. In consideration for the promise of the lifetime care that they desired, the taxpayers agreed to pay a founder's fee of 4,000x dollars upon commencing residence at the home and a monthly fee of 8x dollars.

The fees were calculated without regard to any similar contracts with other patients at the institution and were not medical insurance. The agreement further provided that in the event the taxpayers chose to terminate

residence they would, under certain circumstances, be entitled to a refund of a portion of the founder's fee paid. Such refund would be computed in accordance with a specified formula that included a penalty provision.

The home had not been in operation for a sufficient length of time to demonstrate from its own financial experience what portion of the fees are allocable to medical care of the residents. However, the home used long-term financial information from a comparable retirement home. The home demonstrated that 15 percent of the monthly fee will be used to discharge the home's obligations to provide medical care to its residents, that 10 percent of the founder's fee will be used to provide such care, and that five percent of the founder's fee will be used for construction of the health facilities for the home. The home gave the taxpayers separate statements to that effect.

Section 213(a) of the Code allows as a deduction expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer and the taxpayer's spouse and dependents, subject to certain limitations.

Rev. Rul. 67-185, 1967-1 C.B. 70, holds that where taxpayers pay a monthly life-care fee to a retirement home and prove, on the basis of the home's experience, that a specific portion of the fee covers the costs of providing medical care for them, that portion of the fee is deductible by them as a medical expense in the year paid.

Rev. Rul. 75-302, 1975-2 C.B. 86, involves a taxpayer who, pursuant to a contract with a retirement home to provide lifetime care, including medical care, was required to pay a lump-sum life-care fee, a portion of which was refundable under certain limited circumstances. The home demonstrated, on the basis of its prior experience, that a certain portion of the payment was allocable to the home's obligation to provide medical care to the taxpayer. Rev. Rul. 75-302 holds that, under those circumstances, the portion of the lump-sum life-care fee payment that was properly allocable to the taxpayer's medical care was deductible as an expense for medical care in the year paid, subject to the limitations in section 213 of the Code, and that any refund of the entry fee that is received by the taxpayer in a later year must be included in gross income for such later year to the extent attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year.

Rev. Rul. 68-525, 1968-2 C.B. 112, involves a married couple who, as a condition for receiving a retirement home's promise to provide lifetime care that includes medical care, were required to pay a lump-sum payment that was apportioned between the cost of constructing the infirmary and the residential facilities, and a monthly life-care fee. Rev. Rul. 68-525 holds that the lump-sum payment does not qualify as a medical expense deductible under section 213 of the Code since it is attributable to the construction of the infirmary and residential facility and is not to provide medical care; however, a portion of the monthly fee may be deductible as an expense for medical care in accordance with Rev. Rul. 67-185.

In the instant case, the obligation to pay the founder's fee was incurred at the time payment was made in return for the retirement home's promise to provide lifetime care, and 10 percent of the payment was made in order to secure medical services despite the fact that the medical services were not to be performed until a future time if at all.

Accordingly, the portion of the founder's fee (10 percent, or $400x$ dollars) paid by the taxpayers pursuant to the contract that is properly allocable to their medical care is deductible as an expense for medical care in the year paid, subject to the limitations prescribed in section 213 of the Code.

In addition, the portion of the monthly fee (15 percent or $1.2x$ dollars) paid by the taxpayers that is properly allocable to medical care is also deductible as an expense for medical care in the year paid, subject to the limitations prescribed in section 213 of the Code.

However, the portion of the founder's fee (5 percent or $200x$ dollars) used to construct the health facilities does not qualify as a medical expense deductible under section 213 of the Code. Rev. Rul. 68-525.

Further, any refund of the founder's fee that is received by the taxpayer in a later year must be included in the gross income for such later year to the extent attributable to (and not in excess of) deductions previously allowed under section 213 of the Code.

Section 214.—Expenses for Household and Dependent Care Services Necessary for Gainful Employment [Repealed by section 505(b)(1) of Public Law 94-455, effective for taxable years beginning after December 31, 1975.]

Child and dependent care expenses; meals and lodging furnished to housekeeper. A taxpayer furnishing meals and lodging to a housekeeper employed to provide child and dependent care services may deduct, within the limitations of section 214 of the Code, the allocable out-of-pocket expenditures for the housekeeper's meals and the out-of-pocket lodging expenses attributable to the housekeeper that are in addition to normal expenditures for maintaining the household.

Rev. Rul. 76-288

The Internal Revenue Service has been asked to state its position with respect to the deductibility of the cost of meals and lodging furnished to a

housekeeper where they are furnished in conjunction with specified wages that are deductible, under section 214 of the Internal Revenue Code of 1954, as amounts paid for household services and care of a dependent child, disabled dependent, or disabled spouse, in order that the taxpayer may be gainfully employed.

Held, since the meals furnished to the housekeeper are part of the agreed compensation for the housekeeper's services and the related wages are deductible under section 214 of the Code, the taxpayer's out-of-pocket expenditures for the housekeeper's meals are also deductible within the limitations of section 214. Thus, that portion of the taxpayer's expenditures for food that is allocable to the housekeeper is includible in the computation of the section 214 deduction.

Held further, since the maintenance of a household is a personal expense normally incurred by a taxpayer, the lodging furnished to the housekeeper is not a deductible expense under section 214 of the Code unless it can be shown that the taxpayer made out-of-pocket expenditures directly attributable to the lodging of the housekeeper that were in addition to normal expenditures for maintaining the household; for example, additional rent required when the taxpayer moves to an apartment with an additional bedroom to accommodate the housekeeper and additional utilities attributable to the housekeeper. To the extent that the taxpayer can show additional expenditures for lodging for the housekeeper in the instant case, the taxpayer is entitled to a deduction for such expenditures within the limitations of section 214.

Compare Rev. Rul. 76-106, 1976-1 C.B. 71, which reaches a similar conclusion with respect to the medical expense deduction allowable for expenditures for meals and lodging furnished to an attendant who cares for the disabled taxpayer's personal and medical needs and performs household services, but requires that such amounts be further allocated as between deductible medical expenses and nondeductible personal expenses on the basis of the time spent by the attendant in performing nursing-type services and the time spent performing household and other personal services. This further allocation is required in Rev. Rul. 76-106, because section 262 of the Code provides that no deduction shall be allowed for personal, living, or family expenses, except as otherwise expressly provided, and the deduction expressly provided by section 213 does not extend to amounts paid for household and personal services, but is limited to amounts paid for medical care. This further allocation is not required under section 214, however, since the deduction allowable under section 214 expressly includes amounts paid for household services, in addition to amounts paid for care of a dependent child, disabled dependent, or disabled spouse.

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26 CFR 1.214A-1: Certain expenses to enable individuals to be gainfully employed for taxable years beginning after December 31, 1971.

Employment-related expenses; payments for household and dependent care during absence from work due to illness. Amounts paid by a taxpayer to a housekeeper for qualified household and dependent care services during a 6-month period the taxpayer was absent from work on account of illness and received wage continuation payments that qualified for exclusion as sick pay are not deductible employment-related expenses within the meaning of section 214(b)(2) of the Code.

Rev. Rul. 76-278

Advice has been requested whether, under the circumstances described below, amounts paid by an individual for household services and dependent care during a period when the individual was absent from work on account of sickness are employment-related expenses within the meaning of section 214(b)(2) of the Internal Revenue Code of 1954, so as to qualify for the deduction provided under section 214(a) as expenses for household and dependent care services necessary for gainful employment.

The individual, *B*, a taxpayer who files tax returns on a calendar year basis, is the custodial parent of two children under 15 years of age who are "qualifying individuals" under section 214(b)(1) of the Code. In order that the children might be cared for while *B* was gainfully employed away from home in the daytime, *B* hired a nonrelative as a housekeeper for a stated salary per month. *B*'s expenditures for the housekeeper's salary met the requirements for deductibility as expenses for household and dependent care under section 214.

B's employment of the housekeeper continued during a 6-month period in 1974 when *B* was absent from work on account of an illness that required treatment for two full months in a hospital and for four full months at home where *B* received medication and therapy administered by a visiting nurse. During this 6-month period, *B* performed no employment services. *B* received payments under the employer's wage continuation plan for the entire 6-month period of absence and thereafter returned to work at the regular job. The payments *B* received for this 6-month period of absence qualified for exclusion as sick pay within the limitations of section 105(d) of the Code.

Section 214(a) of the Code provides that in the case of an individual who maintains a household that includes as a member one or more qualifying individuals, there shall be allowed as a deduction, subject to certain limitations, the employment-related expenses paid by the individual during the taxable year. A qualifying individual, under section 214(b), includes a dependent of the taxpayer who is under the age of 15 and with respect to

whom the taxpayer is entitled to a deduction under section 151(e).

"Employment-related expenses" are defined in section 214(b) of the Code as amounts paid for (A) expenses for household services, and (B) expenses for the care of a qualifying individual, but only if such expenses are incurred to enable the taxpayer to be gainfully employed.

Thus, in order for an amount to be recognized as an employment-related expense, it must be determined both (1) that the taxpayer making the expenditure was gainfully employed or in search of gainful employment during the period the expenses were incurred, and (2) that the taxpayer's payments for household and dependent care services for that period were, in fact, incurred for the purpose of enabling the taxpayer to be gainfully employed. Whether an expense is incurred for the purpose of enabling the taxpayer to be gainfully employed depends on the facts and circumstances of each particular case.

Since, in the instant case, *B* continued to be compensated through the employer's wage continuation plan during the period of illness, retaining status as an employee with the expectation of returning to work upon recovery, it is concluded that *B* was gainfully employed throughout that period.

However, *B*'s payments for household and dependent care services during the period of illness were not incurred for the purpose of enabling *B*'s gainful employment since such payments did not contribute to *B*'s ability to be gainfully employed during that period.

Accordingly, the amounts *B* paid the housekeeper for household services and dependent care during the 6-month period when *B* was absent from work on account of sickness are not employment-related expenses within the meaning of section 214(b)(2) of the Code, so as to qualify for the deduction provided under section 214.

Section 216.—Deduction of Taxes, Interest, and Business Depreciation by Cooperative Housing Corporation Tenant-Stockholder

26 CFR 1.216-1: Amounts representing taxes and interest paid to cooperative housing corporation.

Interest deduction; cooperative housing corporation tenant-shareholders. Tenant-shareholders of a cooperative housing corporation may deduct their proportionate share of interest deductible by the corporation on indebtedness it incurred in acquiring its land and building, which were acquired by the purchase of all the stock in the corporation that owned the property, followed by a statutory merger of the acquired corporation into the housing corporation.

Rev. Rul. 76-397

Advice has been requested whether, under the circumstances described below, the tenant-stockholders of a cooperative housing corporation may deduct their proportionate share of interest on indebtedness incurred by the corporation.

X Corporation, which qualifies as a "cooperative housing corporation" as defined in section 216(b)(1) of the Internal Revenue Code of 1954, acquired its apartment building and the land on which the building is situated by purchasing from *Y* Corporation all the stock of *Z* Corporation. The only assets of *Z* were the land and the building. At the time of the stock purchase, *X* paid cash and gave to *Y* a note secured by a mortgage on the property as payment for the *Z* stock. As required by the agreement of sale between *X* and *Y*, the stock purchase was immediately followed by a statutory merger of *Z* into *X*. Upon liquidation of *Z*, title to the property became vested in *X*.

Section 216(a) of the Code provides, in part, that a tenant-stockholder in a cooperative housing corporation shall be allowed a deduction for amounts paid or accrued to the corporation within the taxable year to the extent such amounts represent the tenant-stockholder's proportionate share of interest allowable as a deduction to the corporation under section 163 that is paid or incurred by the corporation on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of the building, or in the acquisition of the land on which the apartment building is situated.

One of the instances in which a deduction is available under section 216 of the Code is where interest is paid or incurred by the corporation on its indebtedness contracted in the acquisition of its land or apartment building. In the instant case, the interest on the note was incurred by the corporation in the acquisition of the stock of the corporation, *Z*, that owned the land and building. However, the purchase agreement between *X* and *Y* required that *Z* be merged into *X* immediately after *X*'s purchase of the stock. Thus, *X*'s purchase of *Z* stock, followed by the merger of *Z* into *X*, was merely the initial step of a prearranged plan to liquidate *Z* into *X* and was an integral part of a plan for acquisition of the land and apartment building. Therefore, for purposes of section 216(a), *X*'s purchase of the *Z* stock and the immediate liquidation of *Z* thereafter will be considered the acquisition by *X* of the land and building, and the indebtedness incurred by *X* in the acquisition of the *Z* stock will be considered an indebtedness incurred in the acquisition of the land and building. See *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F. 2d 718 (5th Cir. 1950), *cert. denied*, 342 U.S. 827 (1951).

Accordingly, in the instant case, the tenant-stockholders of *X* may deduct their proportionate share of the interest allowable as a deduction to *X* under section 163 of the Code on the

indebtedness incurred by X in its acquisition of the land and building.

Part IX.—Items Not Deductible

Section 262.—Personal, Living, and Family Expenses

26 CFR 1.262-1: Personal, living, and family expenses.
(Also Sections 62, 162, 3402, 7805; 1.62-1, 1.162-1, 31.3402(a)-1, 301.7805-1.)

Transportation expenses. Examples illustrate that certain transportation expenses incurred after 1976 in traveling between a taxpayer's residence and place of work, even though temporary, will be nondeductible commuting expenses, regardless of the nature of the work performed, the distance traveled, the mode of transport, or the degree of necessity. Reimbursement received after 1976 for such expense will be considered "wages" for purposes of the FICA, FUTA, and income tax withholding. Rev. Ruls. 190 and 59-371 revoked; Rev. Ruls. 54-497, 55-109, 61-67, and 63-82 modified.

Rev. Rul. 76-453

In view of recent court decisions regarding expenses incurred by an individual (who is not traveling away from home) for daily transportation between the individual's residence and place of work, the Internal Revenue Service has reconsidered the positions in Rev. Rul. 190, 1953-2 C.B. 303, and Rev. Rul. 59-371, 1959-2 C.B. 236.

Rev. Rul. 190 holds that (1) daily transportation expenses incurred by construction workers, in going between a metropolitan area (in which they live and ordinarily work at various temporary jobs) and a temporary work location outside such area, are deductible business expenses; and (2) allowances paid by an employer as reimbursement for such expenses are not "wages" for Federal employment tax purposes including income tax withholding.

Rev. Rul. 59-371 sets forth rules concerning what is "temporary" employment for the purposes of Rev. Rul. 190 and for the purposes of withholding income tax on amounts paid to and received by employees as daily transportation allowances and per diem allowances while working on construction and other projects.

Section 162(a) of the Internal Revenue Code of 1954 in general provides that a deduction will be allowed for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 162(a)(2) specifically provides that the section 162(a) deduction shall include traveling expenses incurred while away from home in the pursuit of a trade or business.

In defining the term "adjusted gross income" section 62 of the Code provides, in part, that allowable transportation expenses paid or incurred by a taxpayer in connection with the performance of services as a self-employed individual or as an employee are deductible from gross income as trade or business expenses.

Section 262 of the Code provides that, except as otherwise expressly provided, no deduction shall be allowed for personal, living, or family expenses.

Sections 1.62-1(g), 1.162-2(e), and 1.262-1(b)(5) of the Income Tax Regulations provide that deductible business expenses do not include the cost of commuting to and from a place of work since this cost is personal in nature and, thus, nondeductible.

When transportation expenses are incurred by a taxpayer in making daily round trips requiring no sleep or rest between the taxpayer's residence and place of work, the travel expense deduction in section 162(a)(2) of the Code is inapplicable. *United States v. Correll,* 389 U.S. 299 (1967). If the taxpayer is allowed to deduct such expenses, it will be under the general expense provisions of section 162(a).

In *William B. Turner,* 56 T.C. 27 (1971), the United States Tax Court in a reviewed opinion held that the transportation expenses incurred by the taxpayer in going between the taxpayer's residence and temporary place of business were not deductible business expenses under section 162(a) of the Code, but rather were nondeductible commuting expenses. The court, at 33, went on to state that:

> Commuting is commuting, regardless of the nature of the work engaged in, the distance traveled or the mode of transportation used. Our path herein was carefully charted in *United States v. Tauferner,* [407 F. 2d 243 (10th Cir. 1969], *cert. denied,* 396 U.S. 824 (1969)] at 246, where the Court of Appeals said:
>
> The basic and unmodified fact of whether the taxpayer is going to the place where he begins work or is returning from the place where he ceases work should be determinative. Such travels are expenses within section 262 as "personal, living or family expenses" whether in an urban, suburban, or rural setting. They are not ordinary business expenses under section 162(a).
>
> See also the recent decision in *Sanders v. Commissioner,* [439 F. 2d 296 (9th Cir. 1971), *cert. denied,* 404 U.S. 964 (1971)].

The decision in *Turner* is premised on the court's conclusion that the "temporary" nature of a taxpayer's work does not convert commuting expenses into ordinary and necessary business expenses.

The *Turner* decision has subsequently been followed in *Crowson v. Commissioner,* T.C. Memo. 1971-223; *Gurney v. Commissioner,* T.C. Memo. 1971-329; *Hill v. Commissioner,* T.C. Memo. 1972-7; *Smith v. Commissioner,* T.C. Memo. 1972-148.

Upon reconsideration of the issue, the Service will follow the *Turner, Crowson, Gurney, Hill* and *Smith* decisions.

Accordingly, where a taxpayer incurs transportation expenses in going between the taxpayer's residence and place of work even though temporary, such expenses are nondeductible commuting expenses, regardless of the nature of the work engaged in, the distance traveled, the mode of transportation used, or the degree of necessity.

In addition, where the taxpayer who incurs such daily transportation expenses is an employee and is reim-

bursed for such expenses by the employer, such payments are includible in gross income and are "wages" for purposes of the provisions of Chapters 21, 23, and 24 of the Code.

The application of this Revenue Ruling is illustrated by the following examples:

Example (1). The distance between an individual's residence and regular and only place of work is 70 miles each way. The individual makes this trip daily by automobile. No deduction is allowable for such daily transportation expenses.

Example (2). Each day, for a two-week period, an individual having no principal or regular place of business drives 70 miles each way between the individual's residence and a temporary work assignment. No deduction is allowable for such daily transportation expenses.

Example (3). *A*, a self-employed individual, maintains a principal place of work in a downtown office building. In order to attend a business meeting in a distant city, *A* drives directly from *A*'s residence to an airport, flies to the distant city, and later that same day returns directly to *A*'s residence. Due to the length of time required to make the trip and attend the meeting, it is not reasonable to expect *A* to stop at the office on the way out of town and on the way back. However, in effect, *A* is traveling between one work location and another. Transportation costs incurred between work locations are deductible business expenses. See Rev. Rul. 55-109, 1955-1 C.B. 261. Therefore, *A* should be entitled to deduct the lesser of (1) the expenses incurred in traveling between *A*'s residence and the business meeting and (2) the expenses that would have been incurred if *A* had traveled between *A*'s office and the business meeting by the same mode or modes of transportation.

However, because the difference between (1) and (2) is generally *de minimis* compared with the total transportation expenses incurred for the trip, the Service will allow *A* to deduct the expenses incurred in traveling between *A*'s home and the business meeting.

Example (4). Assume the same facts as in example (3) except that *B* is an employee and is reimbursed by *B*'s employer, under an expense allowance arrangement, for the expenses of transportation incurred on the trip. Under such arrangement *B* is required to and does account to the employer for such expenses. *B* is allowed the same transportation expenses as taxpayer *A* may deduct in example (3). *B* does not need to report the amount of the reimbursement on *B*'s Federal income tax return since *B* is required to and does account to the employer for the expenses for which reimbursement is made and the reimbursement does not exceed the deductible expenses.

Example (5). During an entire taxable year, employee *C* works at various temporary locations for periods of not more than one month at any one location. *C* drives varying distances each way between *C*'s residence and each such temporary work location. *C*, pursuant to an union agreement, received a flat $7 daily amount as reimbursement for the transportation costs incurred. *C* is not required to account to the employer for such expenses.

C has not incurred any deductible transportation expenses in going between the residence and each such work location. Further, the daily reimbursements are includible in *C*'s gross income and must be reported on the income tax return filed. In addition, withholding of income tax by the employer is required with respect to such transportation reimbursements.

Example (6). *D*, an individual, who regularly works and resides at home, makes daily round trips to and from another work location, which is *D*'s principal place of work. No portion of the transportation expenses incurred for the daily round trips is deductible.

In addition, with regard to *D*'s work at home (which is considered *D*'s minor place of work), if *D*, after returning home from the principal place of work, goes to one or more other work locations, the transportation expenses incurred in going from *D*'s home to the first work location and in returning home from the last such location are not deductible.

Example (7). *E*, who has several regular places of work, may drive from home to one or more than one place of work on any given work day. On the days that *E* drives to only one place of work and then returns home, no deduction is allowable for the cost of such transportation, including any parking costs incurred. On the days that involve stops at more than one place of work, no deduction is allowed for the cost of transportation from *E*'s home to the first work location and from the last work location back home. Transportation costs incurred between work locations are deductible business expenses. See Rev. Rul. 55-109.

Example (8). *F*, who regularly works in an office located other than at *F*'s residence, has duties that require activities in that office and at various other locations with clients. On any given day *F* may (1) go directly from home to the office and return home from the office; (2) go from home to the office, later go to see a client during the day, and then return home; or (3) go from home directly to see a client, later go to the office, and then return home. In each situation, *F* has not incurred any deductible transportation expenses for any of the costs incurred in going from home to the first work location and in returning home from the last work location.

Example (9). Assume the same facts as in example (8) except that on a day spent entirely in the office, *F*, after returning to the residence for dinner, goes back to the office in the evening to meet with a client. No deduction is allowable for the transportation expenses incurred for either the daytime round trip or the evening round trip.

Example (10). Assume the same facts as in example (9) except that the evening meeting with the client is at a

location other than *F*'s office. No deduction is allowable for the transportation expenses incurred for either the daytime round trip or the evening round trip.

Example (11). Assume the same facts as in example (8) except that *F*'s principal place of work is located at the individual's residence. On days that *F* drives to one or more other places of work, the entire amount of the transportation expenses is deductible.

Under authority provided by section 7805(b) of the Code, this Revenue Ruling will not be applied to transportation costs paid or incurred prior to July 1, 1977.

Rev. Rul. 190 and Rev. Rul. 59-371 are revoked. The following revenue rulings are modified to accord with the position set forth herein: Rev. Rul. 54-497, 1954-2 C.B. 75; Rev. Rul. 55-109; Rev. Rul. 61-67, 1961-1 C.B. 25; and Rev. Rul. 63-82, 1963-1 C.B. 33.

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26 CFR 1.262-1: Personal, living, and family expenses.

Treatment of expenses with respect to a three-family dwelling one unit of which is allocated to personal use and one unit is rented to the taxpayer's relative for less than fair rental value. See Rev. Rul. 76-287, page 80.

Section 263.—Capital Expenditures

26 CFR 1.263(a)-1: Capital expenditures; in general.

Whether an amount paid to a county upon the county's completion of a road improvement program in the vicinity of the taxpayer's property is a capital expenditure. See Rev. Rul. 76-257, page 52.

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26 CFR 1.263(a)-2: Examples of capital expenditures.

Whether the costs of fulfilling prepaid subscriptions acquired by the taxpayer in the liquidation of its subsidiary where such subscriptions were prepaid prior to the acquisition of its stock by the taxpayer are deductible as an ordinary and necessary business expense. See Rev. Rul. 76-520, page 42.

Section 266.—Carrying Charges

26 CFR 1.266-1: Taxes and carrying charges chargeable to capital account and treated as capital items.
(Also Section 1502; 1.1502-13.)

Election to capitalize interest on deferred intercompany transaction. The listing of interest under the heading "deferred intercompany interest" on a schedule of a subsidiary that was attached to the consolidated return of an affiliated group of corporations is a proper election to capitalize interest on an intercompany loan under section 266 of the Code; Rev. Rul. 70-539 distinguished.

Rev. Rul. 76-325

Advice has been requested whether, under the circumstances described below, the taxpayer has made an election under section 266 of the Internal Revenue Code of 1954 to capitalize interest.

P corporation is the common parent of an affiliated group of corporations that have, since 1970, filed a consolidated Federal income tax return on the basis of a fiscal year ending September 30. In January 1975, *S*, one of *P*'s subsidiaries, purchased a machine to be used in its business. The purchase of the machine was financed by an intercompany loan from *P* to *S*, which is an intercompany transaction under section 1.1502-13(a)(1) of the Income Tax Regulations.

In the consolidated Federal income tax return of the affiliated group for their taxable year ending September 30, 1975, the interest on the loan from *P* to *S* was capitalized and treated as a deferred intercompany transaction pursuant to section 1.1502-13(a)(2)(iii) of the regulations. On a schedule of *S*, which was attached to the return, the intercompany interest was separately listed under the heading deferred intercompany interest. In addition, a footnote at the bottom of the schedule stated that the interest was intercompany interest deferred in accordance with section 1.1502-13(c)(1)(ii). However, no statement of the type described in section 1.266-1(c)(3) electing to capitalize such interest was attached or filed.

Section 266 of the Code provides that no deduction shall be allowed for amounts paid or accrued for such taxes and carrying charges as, under the regulations prescribed by the Secretary of the Treasury or the Secretary's delegate, are chargeable to the capital account with respect to property, if the taxpayer elects, in accordance with such regulations, to treat such taxes or charges as so chargeable.

Section 1.266-1(b)(1)(iii) of the regulations provides, in general, that the taxpayer may elect to capitalize certain items, including interest on a loan to purchase personal property.

Section 1.266-1(c)(3) of the regulations provides, in part, that if the taxpayer elects to capitalize an item or items under section 266 of the Code, such election shall be exercised by filing with the original return for the year for which the election is made a statement indicating the item or items that the taxpayer elects to treat as chargeable to the capital account.

Section 1.1502-13(a)(2)(iii) of the regulations provides, in part, that the term deferred intercompany transaction means any other expenditure in a case where the amount of the expenditure is capitalized (for example, prepaid rent, or interest that is included in the basis of property).

Rev. Rul. 70-539, 1970-2 C.B. 70, concerns the question of whether a taxpayer made a valid and binding election to capitalize interest, taxes, and carrying charges under section 266 of the Code by including such amounts in the cost of its property when filing its Federal income tax returns for the years involved therein. That Revenue Ruling holds that inasmuch as the taxpayer did not file a statement with its original returns identifying the item or items it elected to capitalize, the taxpayer did not

make a valid and binding election under section 266. Thus, it was not clearly ascertainable from the information submitted with the taxpayer's return whether the taxpayer had made an election.

In *Kentucky Utilities Co. v. Glenn,* 394 F. 2d 631 (6th Cir. 1968), one of the issues involved was whether the taxpayers had elected to capitalize social security taxes paid on construction work under section 24(a)(7) of the Internal Revenue Code of 1939 (the predecessor of section 266 of the 1954 Code). The taxpayers had treated the social security taxes in the Federal income tax returns for the years involved therein as if they had elected to capitalize such taxes. The taxpayers attached a schedule to their returns that clearly indicated those items that the taxpayers were deducting and those items that the taxpayers were capitalizing. However, no formal statement of election to capitalize was ever made by the taxpayers. The taxpayers amended their returns and filed statements claiming deductions for such taxes. The court held that the taxpayers had made a binding election with their original returns that could not be retroactively changed.

In the instant case, *P* and its subsidiaries did not attach to their consolidated Federal income tax return for the year ended September 30, 1975, a statement specifically electing to capitalize the intercompany interest under section 266 of the Code. However, in a schedule of *S* attached to the return, it was clearly indicated that the intercompany interest was being capitalized and treated as a deferred intercompany transaction in accordance with section 1.1502-13(c)(1)(ii) of the regulations. Pursuant to section 1.1502-13(a)(2)(iii), a deferred intercompany transaction is an expenditure, such as interest, which has been capitalized. Therefore, inasmuch as intercompany interest must be capitalized to be treated as a deferred intercompany transaction, *P* and its subsidiaries have clearly indicated that they intended to treat the intercompany interest as a capital expenditure. Thus, the attached schedule in the instant case is similar to the schedule filed by the taxpayers in *Kentucky Utilities Co. v. Glenn* and is distinguishable from the facts in Rev. Rul. 70-539, in which the taxpayer did not file such a schedule.

Accordingly, *P* and its subsidiaries have made a proper election to capitalize the intercompany interest on the loan from *P* to *S* under section 266 of the Code.

Rev. Rul. 70-539 is distinguished.

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26 CFR 1.266-1: Taxes and carrying charges chargeable to capital account and treated as capital items.

Requirements for making an election under section 174(b) of the Code are distinguishable from the requirements for making an election under section 266. See Rev. Rul. 76-324, page 77.

Section 267.—Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers

26 CFR 1.267(a)-1: Deductions disallowed.

Stock transferred in satisfaction of indebtedness; related taxpayers. The majority stockholder of a family corporation who, in partial satisfaction of an indebtedness to the corporation, transferred to it stock in another corporation resulting in gain on some of the shares and loss on others must report the gain realized and no deduction or offset is allowed for the losses; I.T. 3334 superseded.

Rev. Rul. 76-377 [1]

The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the position set forth in I.T. 3334, 1939-2 C.B. 180.

[1] Prepared pursuant to Rev. Proc. 67-6, 1967-1 C.B 576.

The question presented concerns the Federal income tax treatment of gains realized and losses sustained when an individual taxpayer who is a majority stockholder in a family corporation transfers stock in another corporation to the family corporation in partial satisfaction of the taxpayer's indebtedness to the family corporation.

In 1975, the taxpayer was president of *X* corporation and owned more than 50 percent of its stock, the remainder of stock being owned by members of the taxpayer's family. As of December 31, 1974, the taxpayer owed $71x$ dollars to *X*. During 1975, the taxpayer transferred to *X*, in partial satisfaction of the debt, shares of stock in *Y* corporation, a publicly held corporation, with a fair market value of $65x$ dollars. The transaction resulted in gain with respect to some of the shares of the stock and loss with respect to other shares. Computing the gain or loss on the sale of each block of stock separately, it was found that losses aggregated $10x$ dollars and gains aggregated $9x$ dollars; and that, considering the transfers as a whole, a net loss of $1x$ dollars was sustained.

Section 267(a) of the Internal Revenue Code of 1954 provides, in part, that no deduction shall be allowed in respect of losses from sales or exchanges of property (other than losses in case of distributions in corporate liquidations), directly or indirectly, between persons specified within any one of the paragraphs of subsection (b).

Subsection (b) of section 267 of the Code provides at paragraph (2) that among the persons referred to in subsection (a) is an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.

In *Morris Investment Corporation v. Commissioner,* 156 F.2d 748 (3rd Cir. 1946), *aff'g* 5 T.C. 583 (1945), *cert. denied,* 329 U.S. 788 (1946), a corporation sold certain securities to its controlling stockholder at a lump

sum and claimed a net loss on the transaction by using the losses on some of the securities to offset the gain on others. The United States Circuit Court of Appeals held that the transaction must be construed as a number of distinct sales of the various securities, and since the purchaser owned more than 50 percent of the corporation's stock, losses were not deductible. However, the corporation was held taxable on any gains from the sales.

The question has been raised whether all of the *Y* stock transferred to *X* should be considered as a unit resulting in a net loss of 1*x* dollars or whether each block of stock should be considered as a separate transaction and the gains and losses treated separately.

In view of the decision in *Morris Investment Corporation* and the specific provisions of section 267 of the Code to the effect that no deduction shall be allowed in respect of losses from the sales or exchanges of property between an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned by such individual, the losses sustained by the taxpayer by virtue of the transfer of stock to the corporation may not be offset against the gains derived from such transfer. To allow an offset would permit the deduction of losses specifically prohibited by statute and frustrate the legislative purpose of section 267. Thus, each block of stock transferred should be considered as a separate transaction and the gains and losses treated separately.

Accordingly, in the instant case, the aggregate gain of 9*x* dollars must be reported in gross income by the taxpayer. No deduction from gross income is allowed with respect to the losses of 10*x* dollars pursuant to section 267 of the Code.

I.T. 3334 is superseded, since the position set forth therein is restated under current law in this Revenue Ruling.

Section 269.—Acquisitions Made To Evade Or Avoid Income Tax

26 CFR 1.269-2: Purpose and scope of section 269.
(Also Section 1372; 1.1372-1.)

Small business corporation; creation to avoid tax. The creation of a new domestic corporation to carry on a specific portion of the business of an existing domestic corporation for the primary purpose of gaining the benefits of subchapter "S" is not tax avoidance within the meaning of section 269 of the Code.

Rev. Rul. 76-363

Advice has been requested whether, under the circumstances described below, section 269 of the Internal Revenue Code of 1954 can be applied to disallow any deduction, credit, or other allowance resulting from an election by a corporation to be taxed as a small business corporation under subchapter S.

Corporation *M* was organized in 1967 to engage in the business of selling and distributing certain products. All of its capital stock was owned by *A*. As a convenience to some of its customers, *M* intermittently engaged in the sale and distribution of certain other unrelated products. In 1973 *A* organized corporation *X* to deal on a regular basis exclusively in these other products and *M* discontinued this part of its business. *X* elected, under section 1372 of the Code, to be taxed as a small business corporation under subchapter S of the Code. The principal purpose for the organization of *X* was to secure the benefits of subchapter S.

Section 1372 of the Code provides, in general, that any small business corporation may elect not to be subject to Federal income taxes. If such an election is made, then the income of the corporation is taxed to the stockholders whether distributed or not, and any ordinary corporate loss is passed through and deducted as a business loss by the stockholders. *See* sections 1373 through 1379.

Section 269(a)(1) of the Code provides, in part, that if any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance that such person would not otherwise enjoy, then the Secretary or the Secretary's delegate may disallow such deduction, credit, or other allowance.

Section 1.269-2 of the Income Tax Regulations states, in part, that under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan that the deduction, credit, or other allowance was designed by Congress to effectuate.

In *Modern Home Fire and Casualty Insurance Co.*, 54 T.C. 839 (1970), *acq.*, 1970-2 C.B. xx, the United States Tax Court held that, even if the principal purpose in organizing an electing small business corporation was to allow a shareholder to offset the shareholder's losses against the corporation's undistributed taxable income, the enjoyment of this benefit would be consistent with the intent of Congress to allow shareholders of electing small business corporations to "be taxed directly on the corporation's earnings" and to report "corporate income (whether or not distributed) as their own for tax purposes," *S. Rep. No. 1983*, 85th Cong., 2d sess. 87 (1958), and thus cannot be regarded as tax avoidance by securing a benefit the taxpayer would not otherwise enjoy.

Accordingly, although *A*'s principal purpose in creating *X* was to secure

the benefit of exemption from the corporate income tax, section 269 of the Code does not apply to disallow any deduction, credit, or other allowance resulting from an election by a corporation to be taxed as a small business corporation under subchapter S.

See also Rev. Rul. 70-238, 1970-1 C.B. 61, which holds that the deliberate creation of a subsidiary for the express purpose of qualifying it as a Western Hemisphere Trade Corporation under section 921 of the Code does not amount to tax avoidance within the meaning of section 269 and states that Congress intended to make the special deduction provided by section 922 available to any domestic corporation provided only that it could satisfy the specific requirements of section 921. The same principles are involved in the instant case.

Subchapter C.—Corporate Distributions and Adjustments
Part I.—Distributions by Corporations
Subpart A.—Effects on Recipients

Section 301.—Distributions of Property

26 CFR 1.301-1: Rules applicable with respect to distributions of money and other property.

Treatment of distributions in partial liquidation under section 346(a)(2) of the Code where the proceeds from the partial liquidation are invested prior to their distribution. See Rev. Rul. 76-279, page 99.

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26 CFR 1.301-1: Rules applicable with respect to distributions of money and other property.

Whether that part of the value of a new corporation's stock that is disproportionate relative to cash transferred in exchange therefor by the taxpayer and the taxpayer's controlled corporation is a distribution to the taxpayer from the controlled corporation to reflect true value of the new corporation's stock in hands of each after transaction. See Rev. Rul. 76-454, page 102.

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26 CFR 1.301-1: Rules applicable with respect to distributions of money and other property.

Whether a deficiency distribution is included in the income of a Domestic International Sales Corporation's (DISC) shareholder in the year received notwithstanding that the purpose for such distribution was to qualify the corporation as a DISC for a previous taxable year. See Rev. Rul. 76-499, page 235.

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26 CFR 1.301-1: Rules applicable with respect to distributions of money and other property.

Whether a genuine contraction of a business of a corporation has occurred for purposes of section 364(a)(2) of the Code where there has been no substantial reduction of activities performed by the corporation. See Rev. Rul. 76-526, page 101.

Section 302.—Distributions in Redemption of Stock

26 CFR 1.302-1. General.

Whether, under certain conditions, a cash payment to a beneficial owner of escrowed stock upon return of the stock to the acquiring corporation after a reorganization may be considered a redemption of stock under section 302 of the Code. See Rev. Rul. 76-334, page 108.

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26 CFR 1.302-2: Redemptions not taxable as dividends.

Control reduced by redemption. The redemption by a corporation of its outstanding common stock that resulted in a 4.73 percent reduction of ownership of stock of a taxpayer who had previously owned 27 percent of the stock, with the remaining 73 percent being held in equal portions by three unrelated persons, is a meaningful reduction of the taxpayer's interest in the corporation and is not essentially equivalent to a dividend.

Rev. Rul. 76-364

Advice has been requested whether, under the circumstances described below, a redemption of stock was a redemption that was not essentially equivalent to a dividend under section 302(b)(1) of the Internal Revenue Code of 1954.

Corporation *X* had outstanding one class of stock consisting of 200,000 shares of common stock each of which was entitled to one vote. *A*, an individual, owned 54,000 shares of *X* common stock (27 percent), each of which was entitled to one vote. Because *A* was retired from business, *A* took no active part in the management of *X*. The remaining 146,000 shares of outstanding *X* common stock (73 percent) were held in equal portions by individuals *B*, *C*, and *D*. None of the *X* shareholders were related within the meaning of section 318(a)(1) of the Code.

X redeemed for cash 12,160 shares of its stock held by *A*. After the redemption, *A* owned 41,840 shares of the outstanding stock of *X* which represented 22.27 percent of the 187,840 shares then outstanding. The redemption reduced *A*'s percentage of ownership and voting rights in *X* from 27 percent to 22.27 percent. This reduction in A's percentage ownership in *X* failed to meet the percentage requirement of section 302(b)(2)(C) of the Code.

Section 302(a) of the Code provides, in part, that if a corporation redeems its stock, and if section 302(b)(1), (2), or (3), applies, such redemption will be treated as a distribution in part or full payment in exchange for the stock.

Section 302(b)(1) of the Code provides that section 302(a) will apply if the redemption is not essentially equivalent to a dividend.

Section 302(b)(5) provides, in part, that in determining whether a redemption meets the requirements of section 302(b)(1), the fact that such redemption fails to meet the requirements of section 302(b)(2) will not be taken into account.

In the case of *United States v. Davis*, 397 U.S. 301 (1970), *rehearing denied*, 397 U.S. 1071 (1970), 1970-1 C.B. 62, the Supreme Court of the United States held that in order to qualify under section 302(b)(1) of the Code a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation.

Rev. Rul. 75-502, 1975-2 C.B. 111, indicates factors to be considered in determining whether a reduction in a shareholder's proportionate interest in a corporation results in a meaningful reduction within the meaning of *Davis*. The factors considered relate to a shareholder's right to vote and exercise control, a shareholder's right to participate in current earnings and accumulated surplus, and a shareholder's right to share in net assets on liquidation.

In the instant case, the fact that *A* failed to meet the requirements of section 302(b)(2) of the Code is not to be taken into consideration in determining whether the redemption meets the requirements of section 302(b)(1) as provided in section 302(b)(5). In determining whether the redemption meets the requirements of section 302(b)(1), it is significant that the redemption, in reducing *A*'s interest from 27 percent to 22.27 percent, correspondingly reduced *A*'s right to vote, *A*'s right to earnings, and *A*'s right to share in net assets on liquidation. Moreover, the reduction of *A*'s voting rights from 27 percent to 22.27 percent is meaningful in itself in that it caused *A* to go from a position of holding a block of *X* stock that afforded *A* control of *X* if *A* acted in concert with only one other stockholder, to a position where such action was not possible. Thus, under the facts and circumstances of the instant case, the reduction constitutes a meaningful reduction of *A*'s interest in *X* within the meaning of *Davis*.

Accordingly, the redemption was not essentially equivalent to a dividend within the meaning of section 302(b)(1) of the Code and, therefore, qualified as an exchange under section 302(a).

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26 CFR 1.302-2: Redemptions not taxable as dividends.

Redemption; *de minimis* interest. A corporation's redemption of a portion of its stock, not substantially disproportionate, was not essentially equivalent to a dividend under section 302(b)(1) of the Code with respect to the small number of shares (several hundred out of a total of 28 million) acquired from a family corporation's wholly owned subsidiary that after the redemption is considered to own 96.7 percent of stock previously owned by virtue of the attribution to it of the small number of shares owned by its parent.

Rev. Rul. 76-385

Advice has been requested whether, under the circumstances described below, a redemption of stock was a redemption that was not essentially equivalent to a dividend under section 302(b)(1) of the Internal Revenue Code of 1954.

Corporation *X*, a family corporation, owned all of the stock of corporation *Y*. *X* and *Y* both owned a small number of shares of stock of corporation *Z*. *Z*'s stock is listed on the New York Stock Exchange. It has outstanding one class of stock consisting of 28 million shares of common stock.

Pursuant to a settlement of Federal antitrust litigation, *Z* agreed to divest itself of certain property owned by it. In accordance with this agreement, *Z* offered to distribute the property to its shareholders in redemption of shares of their *Z* stock. The offer was accepted by a portion of the *Z* shareholders, including *Y*. However, *X* did not accept the offer. In redemption of *Y*'s stock in *Z*, *Z* distributed to *Y* a portion of the property required to be divested with a fair market value equal to the fair market value of the *Z* stock surrendered by *Y*. Although the redemption terminated *Y*'s actual ownership of stock of *Z*, *Y* still is considered as owning the *Z* stock owned by *X* after the redemption through the application of the constructive ownership of stock rules of section 318(a)(3)(C) of the Code, which section 302(c) makes applicable to section 302. Thus, when the stock constructively owned by *Y* is considered, calculations indicate that the redemption reduced *Y*'s percentage of ownership of the stock of *Z* from .0001118 percent to .0001081 percent. Based on this reduction, the percentage of stock of *Z* owned by *Y* after the redemption was 96.7 percent of the percentage of stock owned by *Y* before the redemption.

Section 302(a) of the Code provides, in part, that if a corporation redeems its stock, and if section 302(b)(1), (2), or (3) applies, such redemption will be treated as a distribution in part or full payment in exchange for the stock.

Section 302(b)(1) of the Code provides that section 302(a) will apply if the redemption is not essentially equivalent to a dividend. Section 302(b)(2) provides that section 302(a) will apply if the redemption is substantially disproportionate with respect to the shareholder as that term is defined therein. Section 302(b)(3) provides that section 302(a) will apply if the redemption completely terminates the shareholder's interest in the corporation. Section 302(c)(1) provides, with an exception not here relevant, that the constructive ownership rules of section 318(a) apply in determining the ownership of stock for purposes of section 302.

The redemption of *Z*'s stock held by *Y* was not a termination of interest under section 302(b)(3) of the Code because *Y* continued to own, through the application of section 318(a)(3)(C), the *Z* stock held by *X*. Furthermore, the redemption of *Z*'s stock held by *Y* was not substantially disproportionate within the meaning of section 302(b)(2) because the reduction in *Y*'s percentage ownership in *Z* did not meet the percentage requirement of section 302(b)(2)(C).

Section 1.302-2(b) of the Income Tax Regulations relating to section 302(b)(1) of the Code provides, in part, as follows:

The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case.

In *United States v. Davis*, 397 U.S. 301 (1970), *rehearing denied*, 397 U.S. 1071 (1970), 1970-1 C.B. 62, the Supreme Court of the United States held that a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation in order to qualify as not essentially equivalent to a dividend within the meaning of section 302(b)(1) of the Code and that the business purpose of the redemption is irrelevant to this determination. The Supreme Court further held that section 318(a) applies for the purpose of determining whether a distribution is "not essentially equivalent to a dividend" under section 302(b)(1).

One purpose for the enactment of section 302(b)(1) of the Code was to provide capital gain treatment for redemptions of stock held by certain minority shareholders, especially minority holders of preferred stock who exercise no control over corporate affairs. See *S. Rep. No. 1622*, 83rd Cong., 2d Sess., 44-45 (1954).

The redemption in the instant case falls within the category of redemptions Congress intended to exclude from dividend treatment through the enactment of section 302(b)(1) of the Code since the redemption involves a minority shareholder whose relative stock interest in *Z* is minimal and who exercises no control over the affairs of *Z*. In addition, as a result of the redemption, *Y* experienced a reduction of its voting rights, its right to participate in current earnings and accumulated surplus, and its right to share in net assets on liquidation. Thus, under the facts and circumstances of the instant case, the redemption qualifies under section 302(b)(1).

Accordingly, the redemption was not essentially equivalent to a dividend within the meaning of section 302(b)(1) of the Code and, therefore, qualified as an exchange under section 302(a). *See also* Rev. Rul 75-512, 1975-2 C.B. 112, in which a redemption of a minority shareholder's interest in a closely held corporation resulting in a 19 percent reduction in its interest was not essentially equivalent to a dividend.

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26 CFR 1.302-4: Termination of shareholder's interest.

Redemption terminating interest; reacquisition of part of assets. Two years after a corporation redeemed all of the stock of a shareholder, who filed the agreement specified in section 302(c)(2)(A)(iii) of the Code for purposes of qualifying the redemption to prevent attribution of ownership of a son's shares, the former shareholder and unrelated parties formed a new corporation that acquired a division of the redeeming corporation representing approximately 15 percent of its assets. The new corporation is not a "successor corporation" under section 1.302-4(c) of the regulations and the shareholder is not deemed to have reacquired an interest in the redeeming corporation.

Rev. Rul. 76-496

Advice has been requested whether, under the circumstances described below, a corporation is a "successor corporation" within the meaning of that term in section 1.302-4(c) of the Income Tax Regulations.

In 1973, *X* corporation redeemed all of its stock directly owned by *A* who held a 26 percent interest in *X* and who was not active in the management of *X*. *A*, *A*'s son, and *B* owned all the outstanding stock of *X* prior to the redemption. *A* filed the agreement required by section 302(c)(2)(A)(iii) of the Code for the purpose of waiving the constructive ownership of the *X* stock held by the son that was attributed to *A* under section 318(a)(1)(A)(ii). *A*'s redemption thus qualified as a complete termination of interest under section 302(b)(3) and the gain realized was treated as received in exchange for the stock surrendered under section 302(a).

At the time of *A*'s redemption, *X*'s business consisted of four separate manufacturing divisions, each one having been operated by *X* for more than 5 years. The assets of the *Y* division represented approximately 15 percent of the fair market value of *X*'s total assets. Because of engineering and marketing problems experienced over a period of years, *Y* division was not generating an adequate return on the capital invested in the division. Thus, in 1975, *X* advertised the *Y* assets for sale through a financial newspaper having nationwide circulation. *A* and other persons unrelated to *A*, *A*'s son, or *B* believing that they could overcome the problems of *Y* division decided to purchase the *Y* assets. Accordingly, they formed a corporation, *Z*, and became the owners of all of its stock. *Z* then acquired for cash the *Y* assets from *X* at their fair market value in a transaction that was taxable to *X*.

Section 302(a) of the Code provides, in part, that a redemption of stock by a corporation will be treated as an exchange if section 302(b)(1), (2), or (3) applies. Section 302(d) provides that a redemption to which section 302(a) does not apply will be treated as a distribution under section 301 and will be treated as a dividend to the extent provided therein.

Section 302(c)(2)(A) of the Code provides that for purposes of section 302(b)(3), which treats a redemption as an exchange under section 302(a) if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder, the constructive ownership of stock rules of section 318(a)(1) will not apply if (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or em-

ployee), other than an interest as a creditor, (ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and (iii) the distributee, at such time and in such manner as the Secretary or the Secretary's delegate by regulations prescribes, files an agreement to notify the Secretary or the Secretary's delegate of any acquisition described in clause (ii) above.

Section 1.302-4(a) of the regulations provides, in part, that the agreement shall recite that the distributee has not acquired any interest in the corporation since such distribution and that the distributee agrees to notify the district director of any acquisition of such an interest in the corporation. Section 1.302-4(c) provides, in part, that section 302(c)(2)(A) of the Code is to be applied with respect to an interest in a corporation that is a successor corporation to the corporation, the interest in which has been terminated.

Whether a corporation is a "successor corporation" depends upon the facts of the particular case.

In the instant case, the assets sold by *X* to *Z* were disposed of at their fair market value for valid business reasons. The remaining business of *X*, which was very substantial in relationship to the discontinued business, was continued by *X* and *A* did not regain an interest in this business by reason of *Z*'s ownership of the *Y* assets. None of the shareholders of *X* are shareholders of *Z*. None of the tax attributes (for example, earnings and profits, net operating loss carryovers and similar items) of the business discontinued by *X* are taken into account by *Z* for tax purposes.

Accordingly, for the foregoing reasons, *Z* is not considered to be a "successor corporation" within the meaning of that term in section 1.302-4(c) of the regulations.

26 CFR 1.302-4: Termination of shareholder's interest.

Redemption; president and chairman of the board. The redemption of stock owned by an individual shareholder, who retains the positions of president and chairman of the board of directors of the corporation, coupled with the redemption of all the stock held by anyone related to the individual is a termination of the individual's interest within the meaning of section 302(b)(3) of the Code and qualfies as an exchange under section 302(a).

Rev. Rul. 76-524

Advice has been requested whether, under the circumstances described below, a redemption of stock was a termination of a shareholder's interest under section 302(b)(3) of the Internal Revenue Code of 1954.

Corporation *X* had outstanding one class of stock consisting of 100 shares of common stock. *A*, an individual, owned 30 shares of *X* common stock and held positions as president and chairman of the board of directors of *X*. *A*'s spouse, *B*, and their son, *C*, each owned 30 shares of *X* common stock. No other *X* shareholder (all of whom were individuals) was related to *A*, *B*, or *C* within the meaning of section 318(a)(1) of the Code.

X redeemed for cash all of its common stock held by *A*, *B*, and *C*. After the redemption, *A* remained as president and director of *X*.

Section 302(a) of the Code provides, in part, that if a corporation redeems its stock, and if section 302(b)(1), (2) or (3), applies, such redemption will be treated as a distribution in part or full payment in exchange of the stock.

Section 302(b)(3) of the Code provides that section 302(a) will apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

Section 302(c)(1) of the Code provides that section 318(a) will apply in determining the ownership of stock for purposes of this section.

Section 302(c)(2) of the Code provides, in part, that section 318(a)(1) (relating to constructive ownership of stock owned by members of a family) will not be applicable to a distribution described in section 302(b)(3) if immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor, the distributee does not acquire any such interest within 10 years from the date of the distribution, and the distributee files an agreement to notify the Commissioner if the distributee should acquire such an interest within 10 years.

In the instant case, if either *B* or *C* had not redeemed their stock in the same transaction, or if other *X* shareholders were related to *A*, within the meaning of section 318(a)(1) of the Code, the constructive ownership rules would be applicable to *A*'s redemption through section 302(c)(1), and the waiver of attribution provided for by section 302(c)(2) would not be available to *A* if *A* retained the positions of officer and director. A redeeming shareholder, who must waive family attribution so that that shareholder's redemption will qualify as a complete termination of interest under section 302(b)(3), may not retain any interest in the corporation, other than an interest as a creditor.

However, where there is no stock outstanding after the redemption the ownership of which would be attributed to the redeeming shareholder, the waiver rule of section 302(c)(2) of the Code, and the conditions under which waiver can occur, are not applicable. Section 302(b)(3), by itself, places no restriction on the retention of interests in the corporation after the redemption, as long as the entire stock interest is terminated. Thus, if a shareholder's direct stock interest is completely terminated in a

redemption, and that shareholder has no indirect ownership of stock after the redemption through application of the constructive ownership rules of section 318(a)(1), the redemption qualifies under section 302(b)(3) regardless of whether the shareholder retains positions as officer and director.

Accordingly, since *A*'s actual stock ownership was completely terminated in the redemption, and since, after the redemption, *A* had no constructive ownership of stock, the redemption was a termination of a shareholder's interest within the meaning of section 302(b)(3) of the Code, and therefore, qualified as an exchange under section 302(a).

Section 305.—Distributions of Stock and Stock Rights

26 CFR 1.305-2: Distributions in lieu of money.

Stock dividend; option to immediately redeem. A distribution of preferred stock that is immediately redeemable for money at the option of a shareholder gives the shareholder an election to receive either stock or property within the meaning of section 305(b)(1) of the Code and is treated as a distribution of property to which section 301 applies.

Rev. Rul. 76-258

Advice has been requested whether a distribution of preferred stock that is immediately redeemable at the option of a shareholder is an election within the meaning of section 305(b)(1) of the Internal Revenue Code of 1954 and, thus, a distribution of property to which section 301 applies.

X corporation distributed pro rata shares of its preferred stock to the holders of its common stock. The preferred stock is redeemable at any time after the distribution at the option of a shareholder. The preferred stock is redeemable at its par value for money.

Section 305(a) of the Code provides, generally, that gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock, except as otherwise provided in section 305(b).

Section 305(b)(1) of the Code provides, in part, that section 305(a) shall not apply to a distribution by a corporation of its stock and the distribution shall be treated as a distribution of property to which section 301 applies, if the distribution is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock, or (B) in property.

Since the preferred stock is redeemable immediately after the distribution at the option of a shareholder, a shareholder may either hold the preferred stock or have it redeemed for money. Thus, the effect of the immediate redeemability feature of the preferred stock is to give a shareholder an election to receive either stock or property within the meaning of section 305(b)(1)(A) and (B) of the Code.

Accordingly, in the instant case, the distribution is treated as a distribution of property to which section 301 of the Code applies.

Section 306.—Disposition of Certain Stock

26 CFR 1.306-1: General.

Computation of the amount of section 306 stock contributed to a charitable organization that is treated as a charitable contribution for purposes of section 170 of the Code. See Rev. Rul. 76-396, page 55.

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26 CFR 1.306-3: Section 306 stock defined.

Recapitalization; stock for stock; section 306 stock. New voting common shares issued under a plan of recapitalization in which the corporation retained the right of first refusal to purchase at net book value whenever a shareholder desired to dispose of such voting shares are considered common stock for purposes of section 306(c)(1)(B) of the Code and therefore not "section 306 stock"; Rev. Rul. 57-132 distinguished.

Rev. Rul. 76-386

Advice has been requested whether stock issued under the circumstances described below is "common stock" for purposes of section 306(c)(1)(B) of the Internal Revenue Code of 1954.

Pursuant to a plan of recapitalization under section 368(a)(1)(E) of the Code, corporation *X* issued shares of new voting common stock and new nonvoting common stocks pro rata to its shareholders in exchange for shares of its outstanding common stock. The exchange was not taxable pursuant to section 354. *X*'s certificate of incorporation granted to the corporation a 90-day right of first refusal to purchase shares of the newly issued voting common stock at their net book value whenever a shareholder (or legal representative in the case of the shareholder's death or incompetency) desired to sell, assign, transfer, or otherwise dispose of any of such stock. The 90-day period starts upon *X*'s receipt of written notice of a stockholder's disposition decision. However, if the shareholder fails to give the required notice, *X*'s option starts on the date the new voting common stock certificates are presented for transfer on the corporation's books. *X*'s right of first refusal also applies to all subsequent holders of such stock.

Section 306(c)(1)(B) of the Code provides, in part, that "section 306 stock" is stock which is not common stock and (1) which was received by the shareholder selling or otherwise disposing of such stock, in pursuance of a plan of reorganization (within the meaning of section 368(a)), and (ii) with respect to the receipt of which gain or loss to the shareholder was to any extent not recognized by reason of Part III, but only to the extent that either the effect of the transaction was

substantially the same as the receipt of a stock dividend, or the stock was received in exchange for section 306 stock.

Since the shareholders received the new voting common in pursuance of a plan of reorganization (a recapitalization under section 368(a)(1)(E) of the Code), no gain or loss was recognized (under section 354), and the effect of the transaction was substantially the same as the receipt of a stock dividend (the proportionate interest of each shareholder in the corporation's equity remained the same), the remaining issue is whether the new voting common is "common stock" for the purpose of section 306(c)(1)(B).

In Rev. Rul. 57-132, 1957-1 C.B. 115, a class of new nonvoting common stock, issued in a reorganization (recapitalization) under section 368(a)(1)(E) of the Code, was redeemable by its terms at the discretion of the corporation. Although sale or other disposition of such stock would initially result in a lessening of the disposing shareholder's interest in the equity growth of the corporation, a later redemption of that class of stock would restore the "lost" equitable interest of the disposing shareholder, thereby achieving the bailout abuse to which section 306 is directed. Therefore, such stock although labeled common stock was viewed not to be "common stock" for purposes of section 306(c)(1)(B).

In the instant case, however, the new voting common stock, which is common stock in all other respects, is not redeemable, but is merely subject to the corporation's right of first refusal. That right applies only with respect to individual shareholders. Thus, if a shareholder desired to dispose of some or all of the new voting common stock, thereby giving rise to *X*'s right of first refusal, the shareholder will necessarily part with some or all of the interest in the growth of the corporation. This result obtains because either the corporation will in fact exercise its option or it will not and the disposition will be completed. In either case, the disposing shareholder would have irrevocably and irretrievably parted with some or all interest in the equity growth in *X* as respects the then existing shareholders. Therefore, the new voting common stock cannot be used to achieve the prohibited bailout.

Accordingly, in the instant case the new voting common stock, although issued subject to the corporation's right of first refusal, is "common stock" for purposes of section 306(c)(1)(B) of the Code.

See Rev. Rul. 76-387, below, which holds that certain newly issued nonvoting common stock is "common stock" for purposes of section 306(c)(1)(B).

Rev. Rul. 57-132 is distinguished.

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26 CFR 1.306-3: Section 306 stock defined.

Recapitalization; stock for stock; section 306 stock. Class A nonvoting common stock not limited or preferred as to dividends or distributions in liquidation and not by its terms redeemable, received in a recapitalization in exchange for preferred stock of equal value that was section 306 stock, is common stock for purposes of section 306(c)(1)(B) of the Code.

Rev. Rul. 76-387

Advice has been requested whether, under the circumstances set forth below, the class A nonvoting common stock is "common stock" for purposes of section 306(c)(1)(B) of the Internal Revenue Code of 1954.

Corporation *X* had outstanding class A nonvoting common stock, class B voting common stock, and nonvoting preferred stock. The preferred stock was limited and preferred as to dividends, had no dividends in arrears, had a fixed liquidation preference, and was "section 306 stock" within the meaning of section 306(c) of the Code. Neither the class A nor the class B stock was limited or preferred with respect to dividends or distributions in liquidation and neither had a preference over the other in any respect. The only difference between the two classes of common stock was that the class B stock had voting rights while the class A stock did not. Neither the class A stock nor the class B stock was by its terms redeemable.

X desired to simplify its corporate structure by eliminating the preferred stock. Pursuant to a plan of recapitalization, the holders of the preferred stock exchanged such stock solely for shares of class A stock of equal value. The transaction qualified as a reorganization (recapitalization) under section 368(a)(1)(E) of the Code and no gain or loss was recognized to the exchanging shareholders pursuant to section 354. There was no intent to redeem the class A stock when the exchange was made.

Section 306(c)(1)(B) of the Code provides, in part, that "section 306 stock" is any stock, except common stock, that is received by a shareholder in exchange for other "section 306 stock" in pursuance of a plan of reorganization under section 368 with respect to the receipt of which gain or loss to the shareholder was to any extent not recognized. Therefore, if the class A stock in the instant case is "common stock," it is not "section 306 stock" within the meaning of section 306(c)(1)(B). Neither the Code nor the Income Tax Regulations define "common stock" for purposes of section 306.

In determining whether newly issued stock is "common stock" for purposes of section 306 of the Code, the bailout abuse Congress sought to preclude by enactment of that section provides guidance. *See S. Rep. No. 1622*, 83d Cong. 2d Sess. 46 (1954). *See also Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954). A bailout occurs if the stockholders can dispose of their stock in question without a loss of voting control and interest in the unre-

stricted equitable growth of the corporation.

While the class A nonvoting common stock in the instant case can be disposed of without a loss of voting control in *X*, it cannot be disposed of without the shareholder parting irretrievably with an interest in the unrestricted equitable growth of *X* represented by such stock.

Accordingly, the class A nonvoting common stock in the instant case is "common stock" for purposes of section 306(c)(1)(B) of the Code.

See Rev. Rul. 76-386, page 95, this Bulletin, which holds that new voting common stock subject to a corporate right of first refusal that is exercisable only on an individual shareholder basis is "common stock" for purposes of section 306(c)(1)(B) of the Code.

Subpart B.—Effects on Corporation

Section 312.—Effect on Earnings and Profits

26 CFR 1.312-6: Earnings and profits.

Whether a regulated investment company is required to utilize a capital loss carryover to offset the amount of a distribution which it may designate as a capital gain dividend pursuant to section 852(b)(3) of the Code. See Rev. Rul. 76-299, page 211.

Subpart C.—Definitions; Constructive Ownership of Stock

Section 316.—Dividend Defined

26 CFR 1.316-1: Dividends.

Whether a regulated investment company is required to utilize a capital loss carryover to offset the amount of a distribution which it may designate as a capital gain dividend pursuant to section 852(b)(3) of the Code. See Rev. Rul. 76-299, page 211.

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26 CFR 1.316-1: Dividends.

Whether the meaning of the term "dividend" set forth in section 316 of the Code will be applied to the term dividend as it appears in the United States-Federal Republic of Germany Income Tax Convention, as amended by Protocol. See Rev. Rul. 76-435, page 490.

Part II.—Corporate Liquidations
Subpart A.—Effects on Recipients

Section 332.—Complete Liquidations of Subsidiaries

26 CFR 1.332-1: Distributions in liquidation of subsidiary corporation; general. (Also Section 346; 1.346-1.)

Liquidation of subsidiary followed by reincorporation. The sale by a wholly owned subsidiary of one of its two businesses followed by an immediate distribution, under a plan of complete liquidation, of all of its assets, including the sales proceeds, to the parent which 13 days later reincorporated the retained business is in substance a partial liquidation of the subsidiary under section 346(a)(2) of the Code and not a complete liquidation within the meaning of section 332.

Rev. Rul. 76-429

Advice has been requested whether, under the following circumstances, a transaction qualifies as a complete liquidation of a subsidiary corporation under section 332 of the Internal Revenue Code of 1954.

For over 5 years prior to December 31, 1973, corporation *P* had owned all of the stock of corporation *S-1* that had been engaged in two businesses: (1) the manufacture and sale of steel specialty items and (2) the ownership and management of apartment buildings. The net assets attributable to businesses (1) and (2) represented, respectively, 52 and 48 percent of the net fair market value of the assets of *S-1*. All liquid assets on hand were considered to represent the necessary working capital of the two businesses.

On December 31, 1973, *S-1* discontinued the apartment rental business and sold the assets of that business to an unrelated party for cash. On the same date *S-1* adopted a plan of complete liquidation and distributed all of its assets (including the proceeds of the sale) subject to its liabilities to *P* in exchange for the *S-1* stock. *S-1* was then dissolved pursuant to the pertinent state code.

On January 13, 1974, *P* formed a new corporation, *S-2*, in the same state and having the same name as *S-1* and transferred to it all of the assets of the steel business, subject to liabilities, previously conducted by *S-1*, in exchange for all the *S-2* stock. Included in the assets transferred was an amount of liquid assets representing the required working capital of the subject steel business. *S-2* continued to operate the steel business.

Section 332 of the Code provides, in part, for the nonrecognition of gain or loss to a parent corporation upon the receipt of property distributed in complete liquidation of its wholly owned subsidiary.

Section 346(a)(2) of the Code provides in part, that a distribution will be treated as in partial liquidation of a corporation if it is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year. Section 1.346-1(a)(2) of the Income Tax Regulations provides, in part, that a distribution that will qualify as a partial liquidation under section 346(a)(2) is a distribution resulting from a genuine contraction of the corporate business. Under section 331(a)(2) amounts distributed in partial liquidation are treated as received by the shareholder in part or full payment in exchange for the stock.

The incidence of taxation depends upon the substance of a transaction. A transaction must be viewed as a whole, and each step from the commencement of negotiations to final consummation is relevant. The true nature of a transaction cannot be disguised by mere formalisms that exist solely to alter tax liabilities. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), 1945 C.B. 58. In *Gregory v. Helvering*, 293 U.S. 465 (1935),

XIV-1 C.B. 193 (1935), a case that deals with the issue of substance versus form, the Supreme Court of the United States stated, in part, that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." When a step in a transaction is a mere "ritualistic incantation" in order to meet the words of the statute, that step will be ignored and the final result achieved will govern the tax consequences. *Ericsson Screw Machine Products Co.*, 14 T.C. 757 (1950).

The purpose of section 332 of the Code is to permit a tax-free distribution by a subsidiary to a parent corporation when the object of the parent is to effect a *complete* liquidation of the subsidiary. The section was not intended to be used as a vehicle for the distribution of earnings and profits or to effect a *partial* liquidation of the subsidiary tax free. A genuine complete liquidation of a corporation contemplates that the assets will no longer remain in their present form of corporate solution and that the activities will cease to be carried on in corporate form with the same shareholders.

Prior to December 31, 1973, *S-1* was engaged in two businesses: steel fabrication and apartment rentals. On that date *S-1* sold the rental business, and distributed its assets only to have the recipient shareholder *P* reincorporate the steel business assets in a newly formed subsidiary (*S-2*) 13 days later. Thus, the result sought by the parent, *P*, was not the complete liquidation of a subsidiary but the tax-free distribution to the parent of the proceeds received by the subsidiary on sale of the assets of the discontinued business plus the working capital attributed to that business. The liquidation of *S-1* and the incorporation of *S-2* were an attempt through form to meet the requirements of section 332 of the Code. The result desired by *P* could have been achieved through a distribution by *S-1* of the sales proceeds and the working capital attributable to that business. *P* hoped to obtain the tax benefit of section 332 (and section 351 upon a tax-free reincorporation of the steel business) through the additional steps. Thus, there was no genuine complete liquidation of *S-1*.

The effect of the transactions was the same as if *S-1* had distributed these assets in redemption of some of its stock. This distribution is not essentially equivalent to a dividend since there was a substantial contraction of operations of *S-1*. Moreover, the distribution was pursuant to a plan. The fact that the plan was denominated as one of complete liquidation is immaterial since the substance of the plan was a partial liquidation with the distribution occurring within the taxable year in which the plan was adopted or within the succeeding taxable year.

Accordingly, since the transactions in the instant case did not meet the standards of a complete liquidation, the liquidation of *S-1* and the incorporation of *S-2* will be disregarded and the two corporations will be considered the same for Federal income tax purposes. The distribution by *S-1* of a portion of its assets representing the net proceeds resulting from the sale of assets relating to the apartment rental business plus working capital attributable to that business will be viewed as a redemption of a portion of *S-1*'s stock which meets the requirements of a partial liquidation within the meaning of section 346 of the Code. The distribution of this amount is treated by *P* as in full payment in exchange for the stock, as provided in section 331(a)(2). The stock of *S-1* deemed surrendered in redemption will bear the same ratio to the total number of shares outstanding prior to the distribution as the distribution bears to the total fair market value of the net assets of *S-1* prior to the distribution. Rev. Rul. 57-334, 1957-2 C.B. 240.

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26 CFR 1.332-1: Distributions in liquidation of subsidiary corporation; general.

Whether obligations assumed by a parent corporation upon liquidation are currently deductible by the parent corporation for Federal income tax purposes. See Rev. Rul. 76-520, page 42.

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26 CFR 1.332-2: Requirement for nonrecognition of gain or loss.

Rev. Rul. 76-525

The retention by a subsidiary corporation of any property, no matter how small in amount, for the purpose of continuing the operation of its present business or for the purpose of engaging in a new business, will prevent the distribution of the property that is actually distributed to its parent from qualifying as a distribution in complete liquidation within the meaning of section 332 of the Internal Revenue Code of 1954.

As restated herein, Rev. Rul. 66-186, 1966-2 C.B. 112, is superseded.

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26 CFR 1.332-3: Liquidations completed within one taxable year.

Liquidation completed within one taxable year. The "taxable year" referred to in section 332(b)(2) and (b)(3) of the Code is the taxable year of the domestic or foreign corporation distributing its property in complete liquidation to another corporation.

Rev. Rul. 76-317

P, a domestic corporation, owned all of the stock of *S*, a domestic corporation. *S* distributed all of its property to *P* in complete cancellation of all of its stock held by *P*. Section 332(b)(2) of the Internal Revenue Code of 1954 provides, in part, that the nonrecognition of gain or loss provisions of section 332(a) apply to the receipt by a corporation of property distributed in complete liquidation of

another corporation, if "the distribution is by such other corporation in complete cancellation or redemption of all of its stock, and the transfer of all the property occurs within the taxable year." Section 332(b)(3) of the Code provides, in part, that the nonrecognition of gain or loss provisions of section 332(a) apply to the receipt by a corporation of property distributed in complete liquidation of another corporation, if "such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which is made the first of the series of distributions under the plan * * *."

Held, the "taxable year" referred to in sections 332(b)(2) and 332(b)(3) of the Code is the taxable year of the corporation distributing its property in complete liquidation to another corporation.

Held further, this holding is also applicable where the distributing corporation is a foreign corporation.

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26 CFR 1.332-3: Liquidations completed within one taxable year.

Whether rules set forth in Rev. Proc. 63-7 are equally applicable in determining the taxable year of a liquidating foreign corporation for purposes of section 332(b)(2) of the Code. See Rev. Proc. 76-35, page 658.

Section 333.—Election as to Recognition of Gain in Certain Liquidations

26 CFR 1.333-4: Treatment of gain.

Whether cash equal to a shareholder's net share of previously taxed income is distributable without recognition of gain upon liquidation of an electing small business corporation pursuant to section 333 of the Code. See Rev. Rul. 76-347, page 253.

Section 334.—Basis of Property Received in Liquidations

26 CFR 1.334-1: Basis of property received in liquidations.

Whether obligations assumed by a parent corporation in liquidation of its subsidiary corporation are added to the parent's basis in the assets acquired from the subsidiary corporation. See Rev. Rul. 76-520, page 42.

Subpart D.—Definition

Section 346.—Partial Liquidation Defined

26 CFR 1.346-1: Partial liquidation. (Also Section 301; 1.301-1.)

Distributions in partial liquidation; sale proceeds invested. Examples illustrate the treatment, under section 346(a)(2) of the Code, of distributions to shareholders of the proceeds from the sale of part of a corporation's business that were temporarily invested by the corporation to preserve the funds and the investment resulted in a profit or a loss; Rev. Rul. 71-250 amplified.

Rev. Rul. 76-279

Advice has been requested whether the distributions in the situations described below, which situations are variations of Rev. Rul. 71-250, 1971-1 C.B. 112, qualify as distributions in partial liquidation under section 346(a)(2) of the Internal Revenue Code of 1954.

In Rev. Rul. 71-250 a corporation that owned and operated three television stations sold one of the stations in July 1970 for 6,000x dollars, realizing net proceeds of 4,500x dollars after expenses and taxes on the sale. The sales proceeds were transferred to a special custodian account at a bank to preserve the funds until a decision could be made as to their use. The bank invested the funds in publicly traded stocks and United States Treasury bills. The corporation considered purchasing other stations with the sales proceeds but no satisfactory arrangement could be consummated. Instead, in December 1970, the corporation adopted a plan of partial liquidation to distribute the funds from the custodian account. Each investment was sold or redeemed at a gain in December 1970, the corporation deriving 200x dollars of gross income.

Under the plan of partial liquidation, the 4,700x dollars of funds from the custodian account were distributed pro rata to the corporation's shareholders in February 1971, in redemption of part of its stock. On these facts, the Internal Revenue Service concluded that the 4,500x dollars was a distribution in partial liquidation under section 346(a)(2) of the Code and 200x dollars was a distribution under section 301.

Situation 1

The facts are the same as in Rev. Rul. 71-250, except that each of the temporary investments resulted in a loss, the total losses being 10x dollars, and 4,500x dollars were distributed pro rata to the corporation's shareholders in February 1971, in redemption of part of its stock.

Situation 2

The facts are the same as in Rev. Rul. 71-250, except that one investment of 3,000x dollars of the proceeds resulted in a loss of 40x dollars, another investment of 1,500x dollars of the proceeds resulted in a profit of 460x dollars, and 4,920x dollars were distributed pro rata to the corporation's shareholders in February 1971, in redemption of part of its stock.

If a corporate distribution qualifies as a partial liquidation as defined in section 346 of the Code, section 331(a)(2) provides that the amounts distributed to shareholders will be treated as in payment for the stock surrendered. Section 346(a)(2) provides that a distribution will be treated as in partial liquidation of a corporation if it is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant

to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year. Section 1.346-1(a)(2) of the Income Tax Regulations provides that if a distribution results from a genuine contraction of the distributing corporation's business, such distribution will qualify as a partial liquidation. On the other hand, the regulation further provides that a distribution of funds accumulated for a planned but abandoned expansion program will not constitute a partial liquidation.

Under section 302(d) a distribution in redemption of stock not in partial liquidation generally is treated as a distribution of property to which section 301 applies if the distribution is not within the provisions of section 302(b). Section 302(b) embraces redemptions not essentially equivalent to dividends, substantially disproportionate as to the shareholder, in termination of shareholder's interest, or of stock issued by a railroad corporation in reorganization.

In situation 1 the maximum amount distributable in partial liquidation is 4,490*x* dollars. Only this amount remaining in the special account is attributable to the genuine contraction of the corporation's business, that is, the sale of the television station. The excess distribution of 10*x* dollars is attributable to the other noncontracted portions of the taxpayer's business and, since it does not come within the provisions of section 302(b) of the Code, will be treated as a distribution under section 301. *See* section 1.302-2(b) of the regulations, relating to pro rata redemptions.

In situation 2 the maximum amount distributable in partial liquidation is 4,460*x* dollars, the sales proceeds minus the investment loss. Again, only this amount is attributable to the genuine contraction of the corporation's business. The excess distribution of 460*x* dollars is attributable to investment gains on the special account, which Rev. Rul. 71-250 provides is not a distribution in partial liquidation, or is attributable to the other noncontracted segments of the taxpayer's business. Since the 460*x* dollars does not come within the provisions of section 302(b) of the Code, it will be treated as a distribution under section 301. *See* section 1.302-2(b) of the regulations, relating to pro rata redemptions.

Rev. Rul. 71-250 is amplified.

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26 CFR 1.346-1: Partial liquidation.

Partial liquidations; contraction of business; working capital distributed. A profitable wholesale appliance distributorship that terminated the business of its retail division, to which it had gradually committed funds over a long period of time to cover operating losses, may include the working capital of the retail division as part of the amount distributable in partial liquidation under section 346(a)(2) of the Code.

Rev. Rul. 76-289

Advice has been requested whether, under the circumstances described below, the working capital of a corporation's terminated retail division may be included as part of the amount distributable in partial liquidation of such corporation within the meaning of section 346(a)(2) of the Internal Revenue Code of 1954.

M corporation, which was actively engaged in conducting a wholesale appliance distributorship and an outlet for the retail sale of appliances for over 30 years, closed its retail division on June 30, 1975. At that time, the retail division had owned and occupied a building that had been used solely for the retail operations. The retail division had its own employees, and its customers and accounting records were separate and distinct from those of the wholesale division.

M closed the retail division because it had incurred operating losses which *M* had been unable to prevent over a period of years. As part of its efforts to make the retail operation profitable, *M* had gradually committed substantial funds to the retail division over the time period involved. The records of *M* indicated that the additional funds invested in the retail division were derived from the profitable operations of the wholesale division.

As a result of the closing of the retail division, corporation *M* had funds available for operations in excess of the requirements of the wholesale division. Pursuant to a plan of partial liquidation adopted in 1976, *M* distributed the building that housed the retail division and the retail division's working capital to its shareholders in redemption of a certain number of shares of the *M* stock.

Section 346(a)(2) of the Code provides that a distribution will qualify as in partial liquidation of a corporation if it is not essentially equivalent to a dividend, is in redemption of a part of the stock of the distributing corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

Section 1.346-1(a) of the Income Tax Regulations provides that a distribution that will qualify as a distribution in partial liquidation of a corporation under section 346(a)(2) of the Code is one which results from a genuine contraction of the corporate business.

Rev. Rul. 60-232, 1960-2 C.B. 115, holds that, in a contraction qualifying pursuant to section 346(a)(2) of the Code, the qualifying amounts distributed will include not only the net proceeds derived from the sale of operating assets, or the operating assets themselves, but also includes that portion of the working capital (including cash) reasonably attributable to the business activity terminated.

Even though the retail division of *M* would not have had any working capital on June 30, 1975, but for the funds supplied to it by *M* from the opera-

tions of the wholesale division, the amount distributed was nevertheless reasonably attributable to the operation of the terminated retail business activity because it was working capital of that division and because it was gradually committed over a period of time to finance the operations of the retail division with a view toward making that division a profitable operation.

Accordingly, the distribution by *M* of the retail division's working capital and the building used by the retail division in redemption of a part of its outstanding stock is a distribution in partial liquidation under section 346 (a) (2) of the Code.

Whether funds constitute working capital of a corporate division depends on all the facts and circumstances of a given case. If in the instant case, there had been no gradual commitment of the funds involved but rather a transfer of such funds immediately before the distribution, such fact would indicate that the funds did not constitute working capital of the retail division and therefore their distribution would not fall within the purview of section 346(a)(2) of the Code but instead would be governed by the provisions of section 301 (relating, in part, to distributions made by corporations that are treated as dividends), or section 302 (relating to distributions in redemption of stock).

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26 CFR 1.346-1: Partial liquidation. (Also Section 301; 1.301-1.)

Partial liquidation; contraction; distribution of real property subject to lease. A corporation's distribution, in redemption of a portion of its stock, of real property managed by an independent management company under contract and subject to a lease which requires the lessee to bear the responsibilities of taxes, maintenance, and equipment operation does not constitute a genuine contraction of the corporation's business, and the distribution does not qualify as a partial liquidation.

Rev. Rul. 76-526

Advice has been requested whether, under the circumstances described below, a distribution qualifies as a partial liquidation within the meaning of section 346(a)(2) of the Internal Revenue Code of 1954.

X corporation owned two parcels of real property (parcel *A* and parcel *B*), each consisting of land and a building thereon. *X* has only one class of stock outstanding. Both parcel *A* and parcel *B* are leased. Under both leases, the lessee is required to pay all real estate taxes and similar assessments and is responsible for all interior maintenance and the operation of the building's equipment.

Both parcel *A* and parcel *B* are the subject of a management agreement whereby another corporation, wholly owned by one of *X*'s shareholders, provides renting, leasing, operating, and managing services. These services include advertising, billing, paying bills (including mortgages), taking care of all phases of repairs and alterations (such as hiring employees and purchasing supplies), obtaining insurance, and enforcing the terms of all contracts.

X distributed parcel *A* pro rata to its shareholders in redemption of a part of their stock. *X* had accumulated earnings and profits in excess of the fair market value of parcel *A*.

At issue in the instant case is whether a genuine contraction of *X*'s business results since *X* itself engaged in no substantial activities with respect to parcel *A*, or with respect to parcel *B*, which is retained by *X*.

Section 331(a)(2) of the Code provides that amounts distributed in partial liquidation of a corporation (as defined in section 346) shall be treated as in part or full payment in exchange for the stock.

Section 346(a)(2) of the Code provides, in part, that a distribution shall be treated as in partial liquidation of a corporation if it is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

Section 1.346-1(a) of the Income Tax Regulations states that a distribution that will qualify as a distribution in partial liquidation of a corporation under section 346(a)(2) of the Code is one that results from a genuine contraction of the corporate business, such as the distribution of unused insurance proceeds recovered as a result of a fire which destroyed part of the business causing a cessation of a part of its activities.

In Rev. Rul. 56-512, 1956-2 C.B. 173, a corporation actively operated a manufacturing business and also owned land that it leased on a royalty basis to a mining company. Under the lease, the lessor was required to engage in no mining or business activities with respect to the land and in fact had not engaged in any such activities. The lessor proposed to distribute the land to its shareholders in partial liquidation. Rev. Rul. 56-512, in holding that the distribution was within the purview of sections 301 and 316 of the Code and not section 346, states that the lessor had not been engaged in the conduct of any trade or business with respect to the leased land, that the ownership of such property does not constitute a trade or business, and that the availability of the land for distribution did not result from the termination of a trade or business by the lessor.

Thus, for purposes of finding that a genuine contraction of a business has occurred for purposes of section 346 (a)(2) of the Code, there must be a substantial reduction of activities performed by the corporation making the distribution. In the instant case, there was no substantial reduction in activities because *X* under its lease and its

management contract has no substantial activities to perform. Thus, the distribution does not constitute a genuine contraction of X's business within the meaning of section 346 (a)(2).

Accordingly, the distribution by X does not qualify as a partial liquidation under section 346(a)(2) of the Code. Therefore, section 346(a) is inapplicable. Since the distribution, because it was pro rata, does not qualify under section 302(a) as payment in exchange for the stock redeemed, the distribution by virtue of section 302(d) is treated as a distribution of property to which section 301 applies. Furthermore, since X had accumulated earnings and profits in excess of the amount distributed, the entire amount of the distribution to each shareholder is taxable as a dividend under the provisions of section 301.

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26 CFR 1.346-1: Partial liquidation.

Whether section 346 of the Code applies to the complete liquidation of a corporation where the effect of the entire transaction for Federal income tax purposes is a partial liquidation of the corporation. See Rev. Rul. 76-429, page 97.

Part III.—Corporate Organizations and Reorganizations
Subpart A.—Corporate Organizations

Section 351.—Transfer to Corporation Controlled by Transferor

26 CFR 1.351-1: Transfer to corporation controlled by transferor.
(Also Section 301; 1.301-1.)

Controlled corporation; disproportionate investments. A corporation, wholly owned by an individual who formed another corporation by purchasing all of its common stock and subsequently causing the first corporation to purchase all of its preferred stock for substantially more money, under a plan of incorporation providing that, upon liquidation, the net assets would be equally distributable to the holders of the common and preferred stock, is treated as having received all of the preferred stock and enough common stock so that the value of the stock received equals the amount paid and then as having distributed the common stock to the individual.

Rev. Rul. 76-454

Advice has been requested concerning the Federal income tax treatment of the transaction described below.

For many years A, an individual, owned all of the stock of X, a domestic corporation. A organized Y, a domestic corporation, paying $50x$ dollars in cash for all of its common stock, and subsequently as part of the plan of incorporation, caused X to purchase from Y all of Y's 4 percent noncumulative, nonvoting preferred stock for $255x$ dollars. Upon liquidation, the net assets of Y are distributable 50 percent to the holders of its common stock and 50 percent to the holders of its preferred stock. Because the right to share in the net assets upon liquidation for each class of stock is substantially disproportionate to the amounts paid for each class of stock, the $255x$ dollars paid by X for the preferred stock exceeds its fair market value.

Section 351(a) of the Internal Revenue Code of 1954 provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. Section 368(c) defines control to mean the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 1.351-1(a)(1) of the Income Tax Regulations states, in part, that it is necessary that transfers to a corporation be simultaneous in order for section 351(a) of the Code to apply where the rights of the parties have been previously defined.

Section 1.351-1(b)(1) of the regulations provides, in part, as follows:

> Where property is transferred to a corporation by two or more persons in exchange for stock or securities * * * it is not required that the stock and securities received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where the stock and securities received are received in disproportion to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts * * *, to pay compensation * * *, or to satisfy obligations of the transferor of any kind.

In the instant case, after the transfers of cash to Y by A and X, A and X owned stock possessing 80 percent or more of the total combined voting power of Y voting stock and 80 percent or more of all other classes of Y stock. Thus, the control requirement of section 351 of the Code is satisfied.

Furthermore, since A received more stock in Y than A would have received if Y had issued its stock in proportion to the cash transferred by A and X, section 1.351-1(b)(1) of the regulations is applicable.

Accordingly, it is appropriate to treat the transactions in the instant case as transfers by X and A, respectively, of $255x$ dollars and $50x$ dollars and the receipt from Y by X and A of stock worth, respectively, $255x$ dollars and $50x$ dollars followed by a distribution by X of a sufficient amount of the stock it constructively received to reflect the true values of the stocks in the hands of X and A after the transactions. That is, X is treated as having received all of the Y preferred stock and enough of the Y common stock so that the total value of the stock it received equalled the $255x$ dollar contribution it made to Y. X is then considered to have distributed the Y

common stock it constructively received to *A* to reflect the fact that after the transaction *X* owned only *Y* preferred stock and *A* owned all of *Y*'s common stock. This distribution is subject to the provisions of section 301 of the Code.

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26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Whether the requirements of section 367 are satisfied so that the transfer of property to a foreign corporation is tax-free under section 351 where the transferor failed to describe in his ruling request certain existing property and liabilities that were transferred and assumed as part of the plan submitted. See Rev. Rul. 76-333, page 104.

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26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Whether there is a recomputation of section 38 credit under section 47(a)(1) of the Code based on less than "substantially all the assets" being transferred to the transferee. See Rev. Rul. 76-514, page 11.

Subpart B.—Effects on Shareholders and Security Holders

Section 355. — Distribution of Stock and Securities of a Controlled Corporation.

26 CFR 1.355-1: Distribution of stock and securities of controlled corporation.

Controlled corporation; business purpose requirement. The pro rata distribution by a corporation of the stock of its wholly owned subsidiary to make the subsidiary's stock acceptable in a proposed merger satisfies the business purpose requirement of section 1.355-2(c) of the regulations.

Rev. Rul. 76-527

Advice has been requested whether the "business purpose" requirement of section 1.355-2(c) of the Income Tax Regulations is satisfied in the following transaction, which is otherwise qualified under section 355 of the Internal Revenue Code of 1954 and the regulations thereunder.

X corporation and *Y* corporation have been engaged in the active conduct of a construction materials production business and a television broadcasting business, respectively, for the last five years. The stock of *X* is widely held by the public. *X* has owned all the outstanding stock of *Y* since it was organized. The construction materials production business accounts for 80 percent of the combined revenue and profits of *X* and *Y*. Based upon advice from its investment analysts, management of *X* believes that the investment community considers *X* to be only a construction materials producer. Management of *Y* has been actively negotiating for the acquisition of the television broadcasting properties of an unrelated corporation, *Z*. *Z*'s management, however, has indicated an unwillingness to accept *Y* stock as consideration, since *Y* is controlled by a corporation whose business is unrelated to television broadcasting.

Thus, *X* proposes to distribute all of the *Y* stock, pro rata, to the *X* shareholders. This distribution will enable the television broadcasting business to use its own stock to make acquisitions in its expansion efforts.

Section 355 of the Code provides, in general, for the tax-free distribution by a corporation to its shareholders of the stock of a controlled subsidiary. For this purpose "control" means, in general, ownership of at least eighty percent of the voting stock and at least eighty percent of the nonvoting stock of a corporation.

Section 1.355-2(c) of the regulations provides that a distribution by a corporation of stock of a controlled corporation will not qualify under section 355 of the Code where carried out for purposes not germane to the business of the corporations, and that the distribution must be incident to a readjustment of corporate structures required by business exigencies.

In order to allow *Y* to use its own stock in the acquisition of the assets of *Z* it was necessary to separate the television broadcasting business of *Y* from the dominant reputation of the construction materials production business of *X* in the investment community.

Therefore, the pro rata distribution by *X* of the *Y* stock to the *X* shareholders will be considered to be carried out for purposes germane to the business of the corporations within the contemplation of section 1.355-2(c) of the regulations.

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26 CFR 1.355-2: Limitations.

Controlled corporation; continuity of interest. The continuity of interest requirement of section 1.355-2(c) of the regulations is satisfied in a transaction in which the 60-percent shareholder of a distributing corporation, a partnership whose equal partners each own an equal number of the corporation's remaining outstanding shares, dissolves and distributes the corporation's stock proportionately to the partners.

Rev. Rul. 76-528

Advice has been requested whether, under the circumstances described below, the continuity of interest requirement of section 1.355-2(c) of the Income Tax Regulations is satisfied.

P corporation owned all of the outstanding stock of *S* corporation for over 5 years during which time *P* had been engaged in the manufacture and sale of wire products and *S* had been engaged in the manufacture and sale of men's clothing. *P* had outstanding only common stock. Sixty percent of the *P* stock was owned by a partnership and each of 4 brothers, *A, B, C,* and *D*, separately owned 10 percent of the *P* stock *A, B, C,* and *D* each owned a 25-percent interest in the partnership.

For good business reasons it was decided that *A* and *B* should be the sole owners of the wire products business and that *C* and *D* should be the sole owners of the men's clothing business. Under the plan, the partnership was

dissolved and the assets (stock interests in *P*) were distributed to its partners. *P* then formed a new corporation, *N*, to which, for good business reasons, it transferred the assets of the wire products business in exchange for all of the *N* stock and the assumption by *N* of the *P* liabilities. The net assets of *N* were equal in value to the net assets of *S*. *P* then distributed the stock of *N* to *A* and *B* and the stock of *S* to *C* and *D*, in each case in exchange for all of their *P* stock, and then dissolved. *A*, *B*, *C*, and *D* each continued to own their respective stock interests in *N* and *S*.

The question presented is whether the continuity of interest requirement of section 1.355-2(c) of the Income Tax Regulations is satisfied in view of the partnership's dissolution as part of the transaction so that the two distributions each qualified as a nontaxable distribution of stock of a controlled corporation within the meaning of section 355 of the Code.

As one of the requirements for a distribution of stock of a controlled corporation to qualify under section 355 of the Code, section 1.355-2(c) of the regulations specifies that those persons who, directly or indirectly, were the owners of the business enterprise prior to the distribution or exchange must maintain a continuity of interest in all or part of such enterprise.

In Rev. Rul. 68-526, 1968-2 C.B. 156, *N* corporation owned 60 percent of *O* corporation. Pursuant to a plan of reorganization and for valid business reasons, *N* and *O* simultaneously transferred all their assets to, and had all their liabilities assumed by, an unrelated corporation, *X*, in exchange for *Y* voting stock. Before the reorganization *X* owned no voting stock of *N* or *O*. *N* and *O* distributed the *X* stock to their shareholders and went out of existence. In each case the transaction qualified as a reorganization under section 368(a)(1)(C) of the Code. In the case of the acquisition of the *O* assets by *X* the transaction qualified notwithstanding that literally there was no continuity of interest in *X* by *N*, the 60-percent shareholder of *O*, in view of the dissolution of *N*. The continuity of interest requirement of section 1.368-1(b) of the regulations was met by the continued stock interest in *X* on the part of shareholders of *N* who became the only parties entitled by the fact of *N*'s dissolution to the *X* stock to which *N* was entitled. See also *Resorts International, Inc.*, 60 T.C. 778 (1973).

Similarly, in the instant case, the partners, *A*, *B*, *C*, and *D*, succeeded to the interests of the partnership upon its dissolution and thus stood in the shoes of the partnership as the only qualified parties to receive and continue the stock interests in *N* and *S* in satisfaction of the continuity of interest requirement of section 1.355-2(c) of the regulations. *A*, *B*, *C*, and *D* did continue to own their respective stock interests in *N* and *S*.

Accordingly, the continuity of interest requirement of section 1.355-2(c) of the regulations is met in the instant case.

Subpart D.—Special Rules; Definitions

Section 367.—Foreign Corporations

26 CFR 1.367-1: Foreign corporations. (Also Section 351; 1.351-1.)

Transfer of property by domestic parent to controlled foreign subsidiary. A domestic corporation that received a favorable ruling under section 367 of the Code and, at the time the transaction was consummated, transferred additional property and liability items not described in the ruling request, must treat the entire transaction as a series of separate transfers in which each gain, but none of the losses, is recognized.

Rev. Rul. 76-333

Advice has been requested concerning the Federal income tax treatment of the transaction described below.

X, a domestic corporation engaged in the business of marketing crude oil as a broker and for its own account, requested and received an advance ruling letter that held that the proposed transfer of certain of its assets, subject to certain of its liabilities, to a newly formed, wholly owned foreign subsidiary corporation would not be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes within the meaning of section 367 of the Internal Revenue Code of 1954. *X*, as part of the plan for consummating the transaction described in the ruling request, transferred certain additional property and liability items not disclosed in its ruling request.

Section 351 of the Code provides, in part, that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Section 367 of the Code provides, in part, that in determining the extent to which gains shall be recognized in the case of an exchange described in section 351, a foreign corporation shall not be considered as a corporation unless before such exchange it has been established to the satisfaction of the Secretary or the Secretary's delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Section 1.367-1 of the Income Tax Regulations provides, in part, that such a planned transaction should be submitted to the Commissioner of Internal Revenue, and that if the transaction is not carried out in accordance with the plan submitted, the Commissioner's approval will not render the transaction tax-free.

Because not all of the items of property transferred and not all of the liabilities assumed in the transaction were disclosed, the transaction was not carried out in accordance with the plan submitted, as required by section 1.367-1 of the regulations. Therefore, the ruling letter did not render the transaction tax-free.

Accordingly, each item of property transferred by *X* to the foreign corporation, both disclosed and undisclosed, will be considered to have been exchanged by *X* for stock of the foreign corporation in a separate taxable exchange and gain will be recognized by *X* on every item on which gain is realized. No loss will be recognized. *See* Rev. Rul. 67-192, 1967-2 C.B. 140.

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26 CFR 1.367-1: Foreign corporations.

Rev. Proc. 76-4 is modified to provide a new effective date for section 367 rulings issued in conjunction with the closing agreements described therein. See Rev. Proc. 76-44, page 668.

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368: Statutory provisions; definitions relating to corporate reorganizations.

T.D. 7422[1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Certain corporate reorganizations

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER
OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

On April 11, 1972, a notice of proposed rule making to amend the Income Tax Regulations (26 CFR Part 1) under sections 358, 362, and 368 of the Internal Revenue Code of 1954, relating to certain corporate reorganizations, was published in the Federal Register (37 F.R. 7162). The following amendments of the regulations, are adopted by this document.

The purpose of the amendment is to provide rules to reflect the amendment of sections 358, 362, and 368 of the Internal Revenue Code of 1954, by section 218 of the Revenue Act of 1964 [Pub. L. 88-272, 1964-1 (Part 2) C.B. 6] and by Pub. L. 90-621 [1968-2 C.B. 769] and to clarify the application of the rules regarding basis in certain reorganizations where the plan of reorganization was adopted before October 23, 1968.

Under the new rules, transactions that may qualify as a reorganization under section 368(a)(1)(B) of the Code include cases where a corporation acquires stock of another corporation in exchange for stock of a corporation in control of the acquiring corporation. In addition, the rules in § 1.358-4(a) and § 1.362-1(b)(1) provide that in the case of a plan of reorganization adopted after October 22, 1968, in which a corporation acquires stock or securities of a corporation a party to such reorganization in exchange for stock or securities of the transferee corporation, the carryover basis rules of section 362 of the Code apply rather than the substituted basis rules of section 358 of the Code. The rules in § 1.358-4(b) and § 1.362-1(b)(2) clarify prior regulations to state that these same rules also apply in the case of a plan of reorganization adopted before October 23, 1968.

The new rules in § 1.368-2(b)(2) provide that a transaction in which substantially all of the properties of a corporation are acquired by merger into the acquiring corporation can qualify as a reorganization under section 368(a)(1)(A) even though stock of a corporation in control of the acquiring corporation is used in the transaction if the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation and no stock of the acquiring corporation is used in the transaction.

The major comments that were received stated that the rules regarding the application of the carryover basis rules of section 362 of the Code instead of the substituted basis rules of section 358 of the Code in a "stock for stock" reorganization should not be applied retroactively. This suggestion was rejected, and the rules adopted do apply retroactively. In addition, comments suggested that in a reorganization qualifying under section 368(a)(1)(A) of the Code by reason of section 368(a)(2)(D), the rules should provide that the controlling corporation is a party to the exchange for purposes of section 357(a) of the Code. This suggestion was adopted, and the rules are accordingly revised.

After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the amendments of the regulations described in the first paragraph of this document are adopted.

Paragraph 1. Section 1.358 is amended by revising subsection (e) of section 358 and the historical note to read as follows:

§ 1.358 Statutory provisions; basis to distributees.

Sec. 358. *Basis to distributees.* * * *

(e) *Exception.* This section shall not apply to property acquired by a corporation by the exchange of its stock or securities (or the stock or securities of a corporation which is in control of the acquiring corporation) as consideration in whole or in part for the transfer of the property to it.

[Sec. 358 as amended by sec. 21, Technical Amendments Act 1958 (72 Stat. 1620) [Pub. L. 85-866, 1958-3 C.B. 254]; sec. 2(a), Act of Oct. 22, 1968 (Pub. L. 90-621, 82 Stat. 1311) [1968-2 C.B. 769]]

Par. 2. Section 1.358-4 is amended to read as follows:

§ 1.358-4 Exceptions.

(a) *Plan of reorganization adopted*

[1] This publication of the Treasury Decision contains the full text of the regulations. The individual instructions for modifying the notice of proposed rulemaking have been omitted.

after October 22, 1968. In the case of a plan of reorganization adopted after October 22, 1968, section 358 does not apply in determining the basis of property acquired by a corporation in connection with such reorganization by the exchange of its stock or securities (or by the exchange of stock or securities of a corporation which is in control of the acquiring corporation) as the consideration in whole or in part for the transfer of the property to it. See section 362 and the regulations pertaining to that section for rules relating to basis to corporations of property acquired in such cases.

(b) *Plan of reorganization adopted before October 23, 1968.* In the case of a plan of reorganization adopted before October 23, 1968, section 358 does not apply in determining the basis of property acquired by a corporation in connection with such reorganization by the issuance of stock or securities of such corporation (or by the issuance of stock or securities of another corporation which is in control of such corporation) as the consideration in whole or in part for the transfer of the property to it. The term "issuance of stock or securities" includes any transfer of stock or securities, including stock or securities which were purchased or were acquired as a contribution to capital. See section 362 and the regulations pertaining to that section for rules relating to basis to corporations of property acquired in such cases.

Par. 3. Section 1.362 is amended by revising subsection (b) of section 362 and by adding a historical note to read as follows:

§ 1.362 Statutory provisions; basis to corporations.

Sec. 362. *Basis to corporations.* * * *

(b) *Transfers to corporations.* If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

* * * * *

[Sec. 362 as amended by sec. 2(b), Act of Oct. 22, 1968 (Pub. L. 90-621, 82 Stat. 1311) [1968-2 C.B. 769]]

Par. 4. Section 1.362-1 is amended to read as follows:

§ 1.362-1 Basis to corporations.

(a) *In general.* Section 362 provides, as a general rule, that if property was acquired on or after June 22, 1954, by a corporation (1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, (2) as paid-in surplus or as a contribution to capital, or (3) in connection with a reorganization to which part III, subchapter C, chapter 1 of the Code applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. (See also § 1.362-2.)

(b) *Exceptions.* (1) In the case of a plan of reorganization adopted after October 22, 1968, section 362 does not apply if the property acquired in connection with such reorganization consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

(2) In the case of a plan of reorganization adopted before October 23, 1968, section 362 does not apply if the property acquired in connection with such reorganization consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee (or, in the case of transactions occurring after December 31, 1963, of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer. The term "issuance of stock or securities" includes any transfer of stock or securities, including stock or securities which were purchased or were acquired as a contribution to capital.

Par. 5. Section 1.368 is amended by revising section 368(a)(1)(B) and (2)(C), by adding a new section 368(a)(2)(D), by revising section 368(b), and by adding a historical note. The revised and added provisions read as follows:

§ 1.368 Statutory provisions; definitions relating to corporation reorganizations.

Sec. 368. *Definitions relating to corporate reorganizations*—(a) *Reorganization*—(1) *In general.* * * *

(B) The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

* * * * *

(2) *Special rules relating to paragraph (1).* * * *

(C) *Transfers of assets or stock to subsidiaries in certain paragraph (1)(A), (1)(B), and (1)(C) cases.* A transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock.

(D) *Statutory merger using stock of controlling corporation.* The acquisition by one corporation, in exchange for stock of a corporation (referred to in this subparagraph as "controlling corporation") which is in control of the acquiring corporation, of substantially all of the properties of another corporation which in the transaction is merged into the acquiring corporation shall not disqualify a transaction under paragraph (1)(A) if (i) such transaction would have qualified under paragraph (1)(A) if the merger had been into the controlling corporation, and (ii) no stock of the acquiring corporation is used in the transaction.

(b) *Party to a reorganization.* For purposes of this part, the term "a party to a reorganization" includes—

(1) A corporation resulting from a reorganization, and

(2) Both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

In the case of a reorganization qualifying under paragraph (1)(B) or (1)(C) of subsection (a), if the stock exchanged for stock or properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to a reorganization" includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1)(A), (1)(B), or (1)(C) of subsection (a) by reason of paragraph (2)(C) of subsection (a), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets or stock are transferred. In the case of a reorganization qualifying under paragraph (1)(A) of subsection (a) by reason of paragraph (2)(D) of that subsection, the term "a party to a reorganization" includes the controlling corporation referred to in such paragraph (2)(D).

* * * * *

[Sec. 368 as amended by sec. 218, Rev. Act 1964 (78 Stat. 57) [Pub. L. 88-272, 1964-1 (Part 2) C.B. 6]; sec. 1, Act of Oct. 22, 1968 (Pub. L. 90-621, 82 Stat. 1310) [1968-2 C.B. 769]]

Par. 6. Paragraphs (b) and (c) of § 1.368-2 are revised to read as follows:

§ 1.368-2 Definition of terms.

* * * * *

(b)(1) In order to qualify as a reorganization under section 368(a)(1)(A) the transaction must be a merger or consolidation effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia.

(2) In order for the transaction to qualify under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(D), one corporation (the acquiring corporation) must acquire substantially all of the properties of another corporation (the acquired corporation) partly or entirely in exchange for stock of a corporation which is in control of the acquiring corporation (the controlling corporation), provided that (i) the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation, and (ii) no stock of the acquiring corporation is used in the transaction. The foregoing test of whether the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation means that the general requirements of a reorganization under section 368(a)(1)(A) (such as a business purpose, continuity of business enterprise, and continuity of interest) must be met in addition to the special requirements of section 368(a)(2)(D). Under this test, it is not relevant whether the merger into the controlling corporation could have been effected pursuant to State or Federal corporation law. The term "substantially all" has the same meaning as it has in section 368(a)(1)(C). Although no stock of the acquiring corporation can be used in the transaction, there is no prohibition (other than the continuity of interest requirement) against using other property, such as cash or securities, of either the acquiring corporation or the parent or both. In addition, the controlling corporation may assume liabilities of the acquired corporation without disqualifying the transaction under section 368(a)(2)(D), and for purposes of section 357(a) the controlling corporation is considered a party to the exchange. For example, if the controlling corporation agrees to substitute its stock for stock of the acquired corporation under an outstanding employee stock option agreement, this assumption of liability will not prevent the transaction from qualifying as a reorganization under section 368(a)(2)(D) and the assumption of liability is not treated as money or other property for purposes of section 361(b). Section 368(a)(2)(D) applies whether or not the controlling corporation (or the acquiring corporation) is formed immediately before the merger, in anticipation of the merger, or after preliminary steps have been taken to merge directly into the controlling corporation. Section 368(a)(2)(D) applies only to statutory mergers occurring after October 22, 1968.

(c) In order to qualify as a "reorganization" under section 368(a)(1)(B), the acquisition by the acquiring corporation of stock of another corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation (or, in the case of transactions occurring after December 31, 1963, solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), and the acquiring corporation must be in control of the other corporation immediately after the transaction. If, for example, corporation X in one transaction exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of stock of corporation Y, the transaction is not a reorganization under section 368(a)(1)(B). Nor is a transaction a reorganization described in section 368(a)(1)(B) if stock is acquired in exchange for voting stock both of the acquiring corporation and of a corporation which is in control of the acquiring corporation. The acquisition of stock of another corporation by the acquiring corporation solely for its voting stock (or solely for voting stock of a corporation which is control of the acquiring corporation) is permitted tax-free even though the acquiring corporation already owns some of the stock of the other corporation. Such an acquisition is permitted tax-free in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months. For example, corporation A purchased 30 percent of the common stock of corporation W (the only class of stock outstanding) for cash in 1939. On March 1, 1955, corporation A offers to exchange its own voting stock for all the stock of corporation W tendered within 6 months from the date of the offer. Within the 6 months' period corporation A ac-

quires an additional 60 percent of stock of corporation W solely for its own voting stock, so that it owns 90 percent of the stock of corporation W. No gain or loss is recognized with respect to the exchanges of stock of corporation A for stock of corporation W. For this purpose, it is immaterial whether such exchanges occurred before corporation A acquired control (80 percent) of the corporation W or after such control was acquired. If corporation A had acquired 80 percent of the stock of corporation W for cash in 1939, it could likewise acquire some or all of the remainder of such stock solely in exchange for its own voting stock without recognition of gain or loss.

* * * * *

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved May 25, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 25, 1976; 8:45 a.m., published in the issue of the Federal Register for June 28, 1976, 41 F.R. 26568)

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26 CFR 1.368-2. Definition of terms. (Also Section 302; 1.302-1.)

Reorganizations; forfeiture and redemption of escrowed stock. The return, in a compromise settlement of claims against an acquired corporation, of escrowed stock of the acquiring corporation by the former stockholders of the acquired corporation in exchange for cash equal to the fair market value of one-half the stock returned does not violate the "solely for voting stock" requirement of section 368 (a)(1)(C) of the Code. The shareholders should treat the transaction as a redemption of one-half of the returned shares and a forfeiture of the other half, resulting in an adjustment to their basis in the remaining shares acquired in the reorganization.

Rev. Rul. 76-334

Advice has been requested, under the circumstances described below, concerning certain of the Federal income tax consequences of the disposition of stock held in escrow pursuant to a plan of reorganization.

Under a plan of reorganization, corporation *Y* acquired all the properties of unrelated corporation *X* solely in exchange for 40,000 shares of voting common stock of *Y* and the assumption by *Y* of the liabilities of *X*. Pursuant to the plan, 10,000 shares of the *Y* stock received by *X* were immediately placed in an escrow account to secure and protect *Y* from any loss arising from a breach of certain representations and warranties made by *X* to *Y* in connection with the transaction. The escrowed stock appeared as issued and outstanding on the balance sheet of *Y* and was legally outstanding pursuant to state law. The shares of *Y* stock were beneficially owned by the *X* shareholders in proportion to their ownership of *X* stock. *X* was promptly dissolved and *X* distributed the *Y* stock to its shareholders and assigned all its right, title, and interest in the escrowed *Y* stock to the *X* shareholders. During the period of the escrow, the *X* shareholders voted the escrowed stock and received dividends paid thereon.

The terms of the escrow agreement provided that the escrow agent would hold the shares of *Y* stock for 6 months, after which time the agent would deliver the escrowed stock pro rata to the *X* shareholders less any shares returned to *Y* in satisfaction of any claim by *Y*. Under the terms of the escrow agreement the escrowed stock was valued at $10x$ dollars per share, the value at the time of the reorganization, for purposes of satisfying claims asserted by *Y*, and *Y*'s sole remedy for any breaches was limited to recovery of the escrowed shares.

Within the 6-month period *Y* asserted certain claims against the escrowed shares in the total amount of $20{,}000x$ dollars. Since these claims were for a lesser amount than the total assigned value of the escrowed shares ($100{,}000x$ dollars), 8,000 shares were delivered, pursuant to the escrow agreement, to the former *X* shareholders at the end of the 6-month period. The former *X* shareholders, however, disputed the claims asserted by *Y* against the remaining 2,000 shares and they engaged in extensive negotiations over a period of about 2 years with *Y* concerning *Y*'s claims to these shares.

During these negotiations *Y* offered to settle the matter, on terms different from those set forth in the escrow agreement, by offering to pay the former *X* shareholders $25{,}000x$ dollars with the remaining 2,000 shares of stock to be delivered to *Y*. This offer was accepted in settlement of the dispute and *Y* distributed $25{,}000x$ dollars pro rata to the former *X* shareholders and the escrow agent delivered the 2,000 shares of *Y* stock to *Y*. At the time of the $25{,}000x$ dollars distribution and the return of the escrowed stock to *Y*, the fair market value of each share of such stock was $25x$ dollars. Thus, the escrow agent returned to *Y* the remaining *Y* stock held in escrow (2,000 shares) with a total value of $50{,}000x$ dollars and the former *X* stockholders were paid a total of $25{,}000x$ dollars by *Y*.

The cash payment by *Y* arose out of the offer by *Y* to settle the dispute with regard to its asserted claims against the escrowed stock. Prior to that offer, there were no agreements between *Y* and the former *X* shareholders relating to any repurchase of

the *Y* stock exchanged in the reorganization.

The issues in the present case are: (1) whether the cash payment of 25,000*x* dollars made by *Y* to the former *X* shareholders violates the solely-for-voting-stock requirement of section 368(a)(1)(C) of the Internal Revenue Code of 1954, and (2) how this cash payment and the return of the escrowed stock should be treated by the former *X* shareholders.

Section 368(a)(1)(C) of the Code provides, in pertinent part, that the term "reorganization" includes the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all of the properties of another corporation. In determining whether the exchange is solely for voting stock, the assumption by the acquiring corporation of a liability of the other is disregarded.

Section 302 of the Code provides rules for the treatment by shareholders of the receipt of property distributed by a corporation in redemption of its stock. Section 317(b) states that stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

When stock issued by the acquiring corporation in a reorganization is placed in escrow by the acquired corporation's shareholders (or placed in escrow by the acquired corporation which assigns all its right, title, and interest to the acquired shareholders) to indemnify the acquiring corporation against breach of warranties, and the acquired corporation's shareholders are entitled to vote the escrowed shares and receive all dividends paid thereon, such stock is treated as transferred to the acquired corporation's shareholders as of the effective date of the reorganization. *See* Rev. Rul. 70-120, 1970-1 C.B. 124. Thus, the former *X* shareholders were the beneficial owners of the *Y* stock held in escrow.

In Rev. Rul. 76-42, 1976-1 C.B. 102, shares of stock issued by the acquiring corporation in a reorganization under section 368(a)(1)(B) of the Code were returned to the acquiring corporation pursuant to an escrow agreement because the earnings of the acquired corporation did not reach specified levels. The number of shares returned was based on their initial negotiated value, and the acquiring corporation's sole remedy for earnings deficiencies was limited to recovery of the escrowed shares. In Rev. Rul. 76-42 it was held the return of the escrowed shares did not result in gain or loss being realized to the shareholder whose escrowed stock was returned.

In the instant case, the cash payment by *Y* to the former *X* shareholders was a transaction separate from the reorganization. The payment arose solely out of the offer by *Y* to settle the dispute under the escrow agreement with regard to its asserted claims. Prior to that offer, there were no agreements between *Y* and the former *X* shareholders relating to the repurchase of any *Y* stock exchanged in the reorganization.

Furthermore, the number of shares to be returned was based on their initial negotiated value and *Y*'s sole remedy for any breaches of *X*'s representations and warranties was limited to the recovery of the escrowed shares.

Accordingly, the cash payment of 25,000*x* dollars made by *Y* to the former *X* shareholders was a separate transaction apart from the reorganization under section 368(a)(1)(C) of the Code and, therefore, did not violate the solely-for-voting-stock requirement of that section.

Further, the cash payment received by each of the former *X* shareholders is a distribution in redemption of a portion of their escrowed stock equal in value on the date of redemption to the cash so received and that the redemption is subject to the provisions and limitations of section 302 of the Code. Therefore, only 1,000 shares (25,000*x* dollars divided by 25*x* dollars a share) are considered redeemed in an arm's length cash redemption, subject to the provisions and limitations of section 302, and the remaining 1,000 shares returned to *Y* are considered as being returned pursuant to the escrow agreement. The shares of the escrowed stock not treated as having been redeemed do not result in gain or loss being realized by the shareholders whose escrowed stock was returned. These shares will be considered returned to *Y* as an adjustment of the amount of consideration received by the former *X* shareholders in exchange for their *X* stock in the tax-free reorganization that results in an adjustment to the adjusted basis of the *Y* stock retained by them.

The following example illustrates these conclusions. In the reorganization exchange an *X* shareholder was entitled to receive 1,600 shares (1/25th) of the 40,000 shares of *Y* stock given in exchange for all of the *X* assets. The shareholder actually received 1,200 of these shares, and the shareholder was the beneficial owner of 400 shares (1/25th) of the 10,000 shares of escrowed stock. Prior to the settlement of the dispute, the shareholder did not sell or otherwise dispose of any of the *Y* stock owned by him. Under section 358 of the Code, the shareholder's basis in the 1,600 shares of *Y* stock is the same as the shareholder's adjusted basis in the shareholder's shares of *X* stock surrendered in the reorganization exchange. The shareholder received 320 (1/25th) of the 8,000 shares of stock released from the escrow and the shareholder was the beneficial owner of 80 (1/25th) of the 2,000 shares of escrowed stock remaining. The shareholder received 1,000*x* dollars (1/25th) as the shareholder's pro rata portion of the 25,000*x* dollars distribution made by *Y*. The shareholder

will treat the 1,000x dollars distributed to the shareholder by Y as received in redemption of 40 shares of the escrowed stock (that portion of the shareholder's escrowed stock equal in value at the time of its return to Y (25x dollars per share) to the cash received), subject to the provisions and limitations of section 302. The remaining 40 shares of escrowed stock are considered as having been returned to Y by the shareholder as an adjustment of the amount of stock received in the reorganization. The adjusted basis of these 40 shares will be added, at the date of their return, proportionately to the adjusted basis of the Y stock held by the shareholder that the shareholder effectively received in the reorganization exchange, including the stock treated as being redeemed, or 1,560 shares. See section 1.302-2(c) of the Income Tax Regulations for a description of a further adjustment to basis that would be required if the amount received in redemption of the 40 shares of Y stock is treated as a distribution of a dividend.

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26 CFR 1.368-2: Definition of terms.

Reorganization; payment of acquired corporation's valuation expenses. The cash payment by the acquiring corporation in a reorganization of expenses incurred by the acquired corporation to evaluate the acquisition offers of the acquiring corporation and others does not violate the solely for voting stock requirement of section 368(a)(1)(C) of the Code.

Rev. Rul. 76-365

Advice has been requested whether the payment of expenses, under the circumstances described below, violates the solely for voting stock requirement of section 368(a)(1)(C) of the Internal Revenue Code of 1954.

All of the stock of corporation X was owned by A, an individual. Pursuant to a plan of reorganization, Y, a corporation whose stock is widely held, acquired all the assets of X in exchange for Y voting common stock and the assumption by Y of all of the liabilities of X in a transaction intended to qualify as a reorganization under section 368(a)(1)(C) of the Code. Prior to this transaction, at the same time that Y made its offer, five other corporations made unsuccessful offers to acquire all the assets and liabilities of X.

In order to evaluate the acquisition offers of the prospective acquiring corporations, X independently hired a financial consultant and an accountant to ascertain the value of the stock of each of the prospective acquiring corporations and was solely liable for the expenses incurred. The fees of these individuals for their services totaled 6x dollars. As part of the plan of reorganization described above, Y made direct cash payments in the total amount of 6x dollars to the consultant and the accountant in satisfaction of the appraisal and accounting expenses incurred by X.

Section 368(a)(1)(C) of the Code provides, in part, that the term "reorganization" means an acquisition by one corporation, in exchange solely for all or a part of its voting stock of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the acquired corporation shall be disregarded.

Rev. Rul. 73-54, 1973-1 C.B. 187, holds that the payment or assumption by an acquiring corporation of valid reorganization expenses solely and directly related to a reorganization under section 368(a)(1)(B) or (C) of the Code does not violate the solely for voting stock requirement of this Code section. However, Rev. Rul. 73-54 also points out that expenses that are not solely and directly related to the reorganization, such as those incurred by an individual shareholder for accounting or investment advice, cannot be assumed or paid by the acquiring corporation without violating the solely for voting stock requirement.

In the present case, the expenses of X incurred to evaluate the acquisition offer of Y are expenses solely and directly related to the plan of reorganization, but those expenses of X incurred to evaluate the acquisition offers of the five unsuccessful corporations were not expenses solely and directly related to the plan of reorganization by which Y acquired all the assets of X and do not constitute valid reorganization expenses within the meaning of Rev. Rul. 73-54. However, the payment of these unrelated expenses should be treated as an assumption of liability of the acquired corporation under section 368(a)(1)(C) of the Code. The unrelated expenses constitute preexisting obligations of X, the nature and amount of which were not determined and fixed in the reorganization in question. *See Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), 1942-1 C.B. 218. Y's payment of these expenses pursuant to the plan of reorganization constitutes an assumption of these liabilities. See Rev. Rul. 74-477, 1974-2 C.B. 116; *Stockton Harbor Industrial Corp. v. Commissioner*, 216 F. 2d 638, 646 (9 Cir. 1954); *Roosevelt Hotel Co.*, 13 T.C. 399, 408 (1949).

Accordingly, under the facts of this case, Y's payment of the reorganization expenses incurred does not violate the solely for voting stock requirement of section 368(a)(1)(C) of the Code. Such payment by Y is viewed as a payment of two separate types of expenses, those expenses that are solely and directly related to the reorganization, and, those expenses that are treated as liabilities of X assumed by Y pursuant to the plan of reorganization.

Part V.—Carryovers

Section 381.—Carryovers in Certain Corporate Acquisitions

26 CFR 1.381(a)-1: General rule relating to carryovers in certain corporate acquisitions.

Whether the gross income of a domestic corporation, the assets of which were acquired in a statutory merger, should be taken into account by the surviving corporation with respect to pre-merger years, in applying the source of income tests of section 861(a)(1)(B) and section 861(a)(2)(A) of the Code. See Rev. Rul. 76-300, page 217.

Subchapter D.—Deferred Compensation, etc.
Part I.—Pension, Profit-Sharing, Stock Bonus Plans, etc.
Subpart A.—General Rule

Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

26 CFR 1.401-1: Qualified pension, profit-sharing, and stock bonus plans.
(Also Section 411; 11.411(b)-1.)

Qualification; pension plan benefits offset by profit-sharing plan benefits. A defined benefit plan that provides a stated benefit offset by the benefits provided by a concurrently operating profit-sharing plan will not fail to satisfy the requirements of section 401 of the Code after September 2, 1974, merely because of the offset provision. Guidelines are provided for determining whether such a plan satisfies the accrued benefit requirements of section 411(b). Rev. Rul. 69-502 superseded.

Rev. Rul. 76-259

The purpose of this Revenue Ruling is to (1) reconsider the position set forth in Rev. Rul. 69-502, 1969-2 C.B. 89, in light of the Employee Retirement Income Security Act of 1974 (ERISA), P.L. 93-406, 1974-3 C.B. 1, and (2) provide guidelines as to how the accrued benefits of a defined benefit plan that are offset by the benefits of a defined contribution plan should be tested to determine whether the accrued benefit requirements of section 411(b) of the Internal Revenue Code of 1954 are satisfied.

Rev. Rul. 69-502 considers an arrangement whereby the employer establishes a profit-sharing plan intended to be qualified under section 401(a) of the Code and also establishes a defined benefit plan which provides a stated benefit offset by the benefits provided by the profit-sharing plan. Rev. Rul. 69-502 finds, in accordance with section 1.401-1(b)(3) of the Income Tax Regulations, that the profit-sharing plan is not for the exclusive benefit of employees because contributions to such plan relieve the employer of the obligation to contribute to the defined benefit plan. Rev. Rul. 69-502 also finds that the defined benefit plan does not provide definitely determinable benefits within the meaning of section 1.401-1(b)(1) of the regulations because such plan benefits are offset by the benefits provided by the profit-sharing plan.

It is the position of the Service that under subchapter D of chapter 1 as amended by ERISA an arrangement described in Rev. Rul. 69-502 does not fail to satisfy the requirements of section 401 of the Code after September 2, 1974, the date of enactment of ERISA, merely because of the type of such arrangement. See section 414(k).

Section 1.401-1(b) of the regulations will be modified to permit such an arrangement.

The defined benefit plan in this arrangement must, however, provide definitely determinable benefits. Such defined benefit plan will not be considered to provide definitely determinable benefits unless the benefit offset by the profit-sharing plan is determined in a manner that precludes discretion on the part of the employer. In particular, the defined benefit plan must provide the actuarial basis that will be employed to determine the benefit deemed to be provided by the profit-sharing plan. Also, the defined benefit plan must specify the time as of which such determination is made (the determination date) in a manner which precludes discretion on the part of the employer.

The defined benefit plan will not fail to provide definitely determinable benefits merely because the profit-sharing plan does not have a definite contribution formula.

A separate issue raised by the arrangement considered in this Revenue Ruling is the method of determining whether the accrued benefit of a defined benefit plan in such an arrangement satisfies the requirements of section 411(b)(1) of the Code. Such accrued benefit will be deemed to satisfy the requirements of section 411(b)(1) of the Code if each of the following two conditions is satisfied:

(1) the accrued benefit under the defined benefit plan determined without regard to the offset derived from the profit-sharing plan satisfies the requirements of section 411(b)(1) of the Code; and

(2) the offset to the benefit otherwise payable is equal to the amount deemed provided on the determination date by the vested portion of the account balance in the profit-sharing plan (plus the additional amount that would have been provided by any prior distribution from the account balance).

The requirements of the second condition in the preceding sentence will not fail to be satisfied merely because the defined benefit plan states that only a specified portion of the vested account balance will be the offset. Thus, for example, in the case of a contributory profit-sharing plan, the defined benefit plan may specify that the offset is limited to the vested portion of the account balance attributable to employer contributions as determined under the profit-sharing plan.

Rev. Rul. 69-502 is hereby superseded effective September 2, 1974.

26 CFR 1.401-1: Qualified pension, profit-sharing, and stock bonus plans.

Incidental benefits; life insurance; profit-sharing or defined contribution plan. The cost of a decreasing amount whole life insurance policy used to provide insurance benefits under a qualified profit-sharing or defined contribution plan will be considered incidental if the aggregate premiums of each participant never exceed 25 percent of the fund allocated to the participant's account.

Rev. Rul. 76-353

The Internal Revenue Service has been asked whether, under a qualified profit-sharing or defined contribution plan, permissible insurance benefits in the situation described below may be considered to be incidental within the meaning of section 1.401-1(b)(1)(i) and (ii) of the Income Tax Regulations if the cost of the insurance benefits is limited to 25 percent, 50 percent, or some other percentage of the funds allocated to a participant's account.

A life insurance company wants to use a decreasing amount whole life policy to provide insurance benefits under a profit-sharing or defined contribution plan qualified under section 401(a) of the Internal Revenue Code of 1954. The decreasing amount whole life policy provides for an amount of insurance which decreases from $2,000 in the first year to $1,000 in the 11th year and remains a level $1,000 thereafter for life.

Section 1.401-1(b)(1)(i) of the regulations provides that a qualified pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise.

Section 1.401-1(b)(1)(ii) of the regulations provides that a profit-sharing plan within the meaning of section 401 of the Code is primarily a plan of deferred compensation but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance.

Rev. Rul. 54-51, 1954-1 C.B. 147, states that life insurance may be considered "incidental" where the aggregate premiums for ordinary life insurance contracts in the case of each participant are less than one-half of the aggregate of the contributions allocated to him at any particular time.

Rev. Rul. 61-164, 1961-2 C.B. 99, states that distributions, in the form of one or more permissible benefits such as life, accident or health insurance (to the extent that each such benefit constitutes a "distribution") will be treated as "incidental" if in the aggregate they do not exceed 25 percent of the funds allocated to a participant's account. In a contract of ordinary life insurance the cost of the pure insurance protection (which alone constitutes a "distribution" to the employee) is approximately one-half of its total cost. The limitations, as to "incidental" use of funds for life, accident or health insurance, in Rev. Ruls. 54-51 and 61-164 above which apply to employee's profit-sharing plans are similarly applicable to money purchase or defined contribution plans. See also Rev. Rul. 66-143, 1966-1 C.B. 79.

A contract of ordinary life insurance within the meaning of Rev. Rul. 54-51 and Rev. Rul. 61-164 is a whole life insurance contract with a level amount of insurance for life, while the contract under consideration provides for a decreasing amount of insurance. The ratio of the pure insurance element to the savings element in a decreasing whole life policy is larger than such ratio in a level amount whole life policy. Therefore, such a contract is not a contract of ordinary life insurance within the meaning of Rev. Rul. 54-51.

Accordingly, the cost of the decreasing amount whole life policy with level premiums will be considered incidental and subordinate to the primary purpose of the profit-sharing or defined contribution plan in accordance with Rev. Rul. 61-164 if the aggregate premiums for the decreasing amount whole life policy in the case of each participant never exceed 25 percent of the funds allocated to the participant's account.

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26 CFR 1.401-1: Qualified pension, profit-sharing, and stock bonus plans.
(Also Section 411; 11.411(a)-8; 11.411(d)-3.)

Plan amendments; vesting schedule and accrued benefits. Employers or other plan sponsors who adopt or amend plans that conform to the requirements set forth in Rev. Proc. 76-31 are permitted thereafter to adopt retroactively plan provisions modifying such terms of the plan as are permitted under final regulations under sections 411(a)(10) and (d)(6) of the Code and sections 203(c)(1) and 204(g) of the Employee Retirement Income Security Act of 1974.

Rev. Rul. 76-378 [1]

SECTION 1. PURPOSE

The purpose of this Revenue Ruling is to provide an interpretation and application, in the case of certain interim plan provisions, of sections 411(a)(10) and 411(d)(6) of the Internal Revenue Code of 1954 and sections 203(c)(1) and 204(g) of the Employee Retirement Income Security Act of 1974 (1974-3 C.B.) ("ERISA"). This Revenue Ruling will facilitate, for employers or other plan sponsors, the utilization of the Special Reliance Procedure by permitting those who adopt or amend plans in conformity with the interim rules of the ERISA Guidelines thereafter to adopt retroactively plan provisions modifying terms of the plan which had been drafted to conform to the ERISA Guidelines in cases where such later plan provisions are permitted under final regulations or rules but were not permitted under the

[1] Also released as IR-1668 dated Sept. 9, 1976.

ERISA Guidelines. However, it is noted in this respect that ERISA affords to a participant or beneficiary the right, independent of action by the Internal Revenue Service or the Department of Labor, to commence a court action under section 502(a) of ERISA to enjoin, or obtain other appropriate equitable relief in respect of, any act or practice which is alleged to violate any provision of Title I of ERISA.

SEC. 2. BACKGROUND

.01 Section 411(a)(10) of the Code and section 203(c)(1) of ERISA require, in the case of plan amendment changing the vesting schedule, that:

(1) the nonforfeitable percentage of the accrued benefit derived from employer contributions (determined as of the later of the date such amendment is adopted, or the date such amendment becomes effective) of any employee who is a participant in the plan must not be less than such nonforfeitable percentage computed under the plan without regard to such amendment, and

(2) each participant having not less than 5 years of service must be permitted to elect, within a reasonable period after the adoption of such amendment, to have his nonforfeitable percentage computed without regard to such amendment.

Any change in any plan provisions that directly or indirectly alters the computation of a participant's nonforfeitable percentage is subject to the requirements of sections 411(a)(10) of the Code and 203(c)(1) of ERISA. An indirect change is any change that affects the computation of a participant's nonforfeitable percentage, such as the counting or crediting of hours of service, years of service, breaks in service, etc., for purposes of determining a participant's nonforfeitable percentage.

.02 Sections 411(d)(6) of the Code and 204(g) of ERISA provide that the accrued benefit of a participant may not be decreased by a plan amendment other than an amendment described in sections 412(c)(8) of the Code and 302(c)(8) of ERISA. Any plan amendment which directly or indirectly reduces the accrued benefit of a participant is subject to the requirements of sections 411(d)(6) of the Code and 204(g) of ERISA. An indirect reduction would, for example, include changes in plan provisions crediting years of service and breaks in service for accrual purposes, changes in any plan provisions relating to actuarial factors for determining optional or early retirement benefits, etc.

.03 Because of the need for immediate guidance to enable the adoption or amendment of plans in conformity with ERISA, some rules were published as temporary regulations or rules. See ERISA Guidelines, Rev. Proc. 76-31, page 649, this Bulletin. If some of the requirements in these temporary regulations or rules which affect either the nonforfeitable percentage or the accrued benefit are changed in final regulations or rules so as to permit a plan provision that was not permitted by the temporary regulations or rules, an employer or other plan sponsor that had adopted a provision to conform with the requirements of the temporary regulations or rules will not be able to amend the plan to incorporate the provision permitted by final regulations or rules except in conformity with the limitations of sections 411(a)(10) and 411(d)(6) of the Code and sections 203(c)(1) and 204(g) of ERISA.

SEC. 3. ADOPTION AND AMENDMENT OF INTERIM PLAN PROVISIONS

In the case of a plan satisfying the requirements of Rev. Proc. 76-31, relating to the Special Reliance Procedure, the adoption of an "interim provision" satisfying the requirements of section 4 and a "final amendment" satisfying the requirements of section 5 will not cause the plan to fail to satisfy the requirements of sections 411(a)(10) and 411(d)(6) of the Code and sections 203(c)(1) and 204(g) of ERISA.

SEC. 4. INTERIM PLAN PROVISIONS

.01 For purposes of section 3, an interim provision is a provision in either a new plan or an amendment to an existing plan:

(1) which conforms to the temporary regulations or rules comprising the ERISA Guidelines;

(2) which is not more liberal to participants or beneficiaries than the minimum requirements of the temporary regulations or rules comprising the ERISA Guidelines;

(3) which is more liberal to participants or beneficiaries than the minimum requirements of the final regulations or rules;

(4) the amendment of which could directly or indirectly alter the computation of a participant's nonforfeitable percentage adversely to the participant or reduce his accrued benefit; and

(5) with respect to which the identification and statement requirements of section 4.02 are satisfied.

Any provision which is more liberal to participants or beneficiaries than that required under the temporary regulations or rules comprising the ERISA Guidelines (such as a provision pursuant to which a participant is credited with hours of service, for purposes of determining years of service, which are not hours required to be counted under 29 CFR 2530.200b-2(a)) shall not be deemed to be an interim provision.

.02 An interim provision satisfies the requirements of this subsection if:

(1) there is set forth conspicuously at the beginning of the formal plan document a statement identifying each plan provision which is to be treated as an interim provision and indicating the interim nature of such provisions, i.e. that the computation of the nonforfeitable percentage may be retro-

actively changed and the accrued benefit may be retroactively reduced;

(2) such statement is included in the plan on or before the latest of (i) the date of the initial adoption of the plan, or the adoption of the first amendment designed to bring the plan into compliance with the provisions of ERISA relating to qualification or with the requirements of section 301(d) of the Tax Reduction Act of 1975, (ii) the date such adoption or amendment is effective, or (iii) December 3, 1976, a date 60 days after the publication in the Internal Revenue Bulletin of Rev. Rul. 76-378.

.03 A sample of an acceptable statement of the kind required by section 4.02 is set forth in the Exhibit.

SEC. 5. FINAL AMENDMENT

.01 For purposes of section 3, a final amendment is a plan amendment:

(1) which amends an interim provision;

(2) which directly or indirectly changes the computation of the nonforfeitable percentage adversely to the participant or reduces the accrued benefit provided under the interim provision (and is permissible under the final regulations or rules);

(3) the provisions of which would not have satisfied the temporary regulations or rules comprising the ERISA Guidelines; and

(4) which satisfies the requirements of section 5.02.

.02 A final amendment satisfies the requirements of this subsection if:

(i) such amendment is in force on or before December 31, 1977;

(2) such amendment applies only to any employee (other than an employee described in section 5.02(3)) who completes at least an hour of service within the meaning of 29 CFR 2530.200b-2(a) in each of the following periods:

(i) from the date the notice described in section 5.02(4) is given through the day before the first date such amendment is in force, and

(ii) from the first date such amendment is in force to the first anniversary of such date;

(3) such amendment is not made applicable to employees who, on or before the first date the final amendment is in force, have either attained the normal retirement age specified in the plan or completed the requirements prescribed by the plan for early retirement;

(4) at least 90 days notice of such amendment is given to employees in service covered by the plan as of the date of such notice: and such notice is written in the manner described in section 102(a)(1) of ERISA and the regulations thereunder, and contains (i) a description of such amendment, (ii) a statement that such amendment will apply only to an employee described in section 5.02(2), other than an employee described in section 5.02 (3), and (iii) a statement as to how the participant may obtain a copy of such amendment; and

(5) such notice is given in the manner described in section 1.7476-2 (c)(1) of the Income Tax Regulations relating to the method of giving notice to interested parties who are present employees.

For purposes of section 5.02, a final amendment shall not be considered to be in force until the date which is 91 days after the date the notice described in section 5.02(4) is given.

.03 Nothing in this Revenue Ruling requires the adoption of a final amendment changing an interim provision merely because the final regulations or rules allow a plan provision that was not permitted by the temporary regulations or rules.

EXHIBIT

"CAUTION: Sections , , and of this plan, concerning accrual and vesting of benefits, are *interim* provisions based on the requirements of the temporary regulations and rules of the Internal Revenue Service and the Department of Labor. If the final regulations and rules of the IRS and the DOL impose less stringent requirements on the Company, the Company reserves the right to amend the interim provisions, to be in force on or before December 31, 1977, to conform to the final regulations and rules. Such an amendment may reduce a plan participant's accrued or vested benefit retroactively. If such an amendment is adopted, plan participants will be notified at least 90 days prior to the first date such amendment is in force. The reduction of benefits will apply only to employees who complete at least one hour of service in both of the following two periods:

(1) the period starting on the date of the 90-day notice and ending on the day before the first date such amendment is in force; and

(2) the period starting on the first date such amendment is in force and ending one year later.

Such amendment will not reduce benefits for employees (i) who have less than one hour of service in either of the two periods above, or (ii) who, on or before the first date such amendment is in force, have reached the normal retirement age stated in section of the plan or have completed the requirements for early retirement stated in section of the plan."

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26 CFR 1.401-1: Qualified pension, profit-sharing, and stock bonus plans.

Procedure for applying interim rules governing qualified employee plans pending the issuance of final rules and regulations. See Rev. Proc. 76-31, page 649.

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26 CFR 1.401-1: Qualified pension, profit-sharing, and stock bonus plans.

Procedures for the issuance of determination and opinion letters as to the qualification of target benefit plans and the status for exemption of related trusts or custodial accounts. See Rev. Proc. 76-38, page 661.

26 CFR 1.401-4: Discrimination as to contributions or benefits.

Discrimination; target benefit plans. Guidelines are provided for determining whether the benefits of a target benefit plan discriminate in favor of employees who are officers, shareholders, or highly compensated.

Rev. Rul. 76-464[1]

SECTION 1. PURPOSE

The purpose of this Revenue Ruling is to provide guidelines for determining whether the benefits of a target benefit plan discriminate in favor of employees who are officers, shareholders, or highly compensated.

SEC. 2. BACKGROUND INFORMATION

Section 401(a)(4) of the Internal Revenue Code of 1954 provides that contributions or benefits shall not discriminate in favor of employees who are officers, shareholders, or highly compensated.

SEC. 3. DEFINITIONS

For purposes of this revenue ruling, the following definitions are applicable.

.01 Target Benefit plan—A target benefit plan is a money purchase pension plan in which:

(1) the plan indicates a stated benefit commencing at the plan's normal retirement date,

(2) contributions necessary to fund the benefit described in paragraph (1) with respect to a participant are determined under the individual level premium funding method using actuarial assumptions or factors stated in the plan,

(3) the contributions determined in paragraph (2), and any forfeitures reducing those contributions, are allocated and separately accounted for with respect to each such participant, and

(4) the benefits provided under the plan are provided solely from the amounts allocated in paragraph (3), employee contributions, and any income, expenses, and gains, reduced by any losses.

A plan will not fail to be a target benefit plan merely because the amount determined in paragraph (3) is limited in order to satisfy the requirements of section 415 of the Code. Nor will a plan fail to be a target benefit plan merely because the amount determined in paragraph (3) is offset by employee contributions.

.02 Targeted Benefit—The benefit described in section 3.01(1).

.03 Anticipated Benefit—A benefit that would be provided under the target benefit plan if the contributions allocated in section 3.01(3) earned not less than 5% nor more than 6% interest compounded annually until the normal retirement date. In the case of a target benefit plan whose benefits are provided in part by insurance contracts, the anticipated benefit is equal to the sum of the benefits provided by the insurance contract and benefits provided in the preceding sentence from the portion of contributions not allocated to insurance contracts.

.04 Pre-Retirement Interest Rate—The rate of interest compounded annually that is embodied in the actuarial assumptions or facts described in section 3.01(2) for the period before the normal retirement date.

.05 Prohibited Group—Employees who are officers, shareholders, or highly compensated.

.06 Rank and File Employees—Employees other than those who are officers, shareholders, or highly compensated.

SEC. 4. GENERAL RULES

.01 The benefits under a target benefit plan will discriminate in favor of the prohibited group unless the anticipated benefits do not discriminate in favor of the prohibited group. Such a plan, however, would satisfy section 401(a)(4) of the Code if contributions do not discriminate in favor of the prohibited group.

.02 If the pre-retirement interest rate of a plan is not less than 5% nor more than 6%, the anticipated benefit is equal to the targeted benefit and, therefore, in applying section 4.01, the targeted benefit may be used in lieu of the anticipated benefit.

.03 If the pre-retirement interest rate is less than 5%, the anticipated benefit will exceed the targeted benefit in a manner disproportionately favoring the class of employees whose contributions described in section 3.01(2) began at younger ages. Thus, the anticipated benefits of such a plan could discriminate in favor of the prohibited group, even if the targeted benefits do not discriminate in favor of the prohibited group if the class of employees described in the previous sentence consists primarily of the prohibited group. Such a plan, however, would satisfy section 401(a)(4) of the Code if the contributions do not discriminate in favor of the prohibited group.

.04 If the pre-retirement interest rate exceeds 6% the anticipated benefits will be less than the targeted benefit. The anticipated benefits relative to the targeted benefit will favor the class of employees whose contributions described in section 3.01(2) began at older ages. Thus, the anticipated benefits of such a plan could discriminate in favor of the prohibited group, even if the targeted benefits do not discriminate in favor of the prohibited if the class of employees described in the previous sentence consists primarily of prohibited group employees. Such a plan, however, would satisfy section 401(a)(4) of the Code if the contributions do not discriminate in favor of the prohibited group.

SEC. 5. TRANSITIONAL RULE

In the case of a target benefit plan in existence on November 5, 1976, whose pre-retirement interest rate exceeds 6% or is less than 5%, such plan may, for purposes of section 4.01, use the targeted benefit in lieu of the an-

[1] Also released as IR-1691, dated November 5, 1976.

ticipated benefit if the pre-retirement interest rate is changed to an interest rate nor exceeding 6% and not less than 5% with respect to new benefits or additional benefits created by changes in compensation, plan provisions, or any other reason.

SEC. 6. EFFECTIVE DATE

This Revenue Ruling applies to plans to which section 415 of the Code applies effective for years beginning after December 31, 1975.

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26 CFR 1.401-4: Discrimination as to contributions or benefits.

Defined contribution plan that fails to require allocation of employer contributions to account of every participant who has more than 1,000 hours of service in an allocation period. See Rev. Rul. 76-250, page 124.

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26 CFR 1.401(a)-14: Commencement of benefits under qualified trusts.

T.D. 7436

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Commencement of benefits under qualified trusts

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C., 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

By a notice of proposed rule making appearing in the Federal Register on October 8, 1975 (40 F.R. 47138), amendments to the Income Tax Regulations (26 CFR Part 1) under section 401(a)(14) of the Internal Revenue Code of 1954, as added by section 1021(d) of the Employee Retirement Income Security Act of 1974 (the "Act") Pub. L. 93-406, 88 Stat. 937) [1974-3 C.B. 1] were proposed in order to provide rules for the commencement of benefits under qualified trusts.

Section 401(a)(14) provides two qualification requirements concerning the commencement of benefit payments. First, unless the participant elects otherwise, the payment of benefits must commence not later than 60 days after the close of the plan year in which the latest of the following events occurs: (1) the participant's attainment of age 65 (or any earlier normal retirement age under the plan), (2) the lapse of ten years since the participant commenced participation in the plan, or (3) the termination of the participant's service with the employer.

Second, if the plan permits an employee who has not separated from the service to receive an early retirement benefit if he meets certain age and service requirements, section 401(a)(14) requires that an employee must be entitled to the payment of certain benefits upon satisfaction of the age requirements if, after satisfying the service requirement, he separated from service with a nonforfeitable right to an accrued benefit. Such benefits must not be less than those to which the separated participant would have been entitled under the plan at the normal retirement age, actuarially reduced according to the regulations.

A public hearing regarding the proposed regulations was held on February 26, 1976, and, after consideration of comments made orally at this hearing and those submitted in writing, the text of the proposed regulations has been revised in several respects.

The text of paragraphs (a) and (c) of the final regulations provide that the provisions of these paragraphs do not preclude a plan from requiring that a participant file a claim for benefits before payment of benefits will commence. However, in the event that regulations relating to plan recordkeeping requirements are issued by the Department of Labor, this provision will be reconsidered.

Paragraph (c) (relating to the special early retirement rule) has been revised to provide that it is permissible, under the terms of a plan, to impose reasonable conditions to payment of early retirement benefits so long as such conditions are equally applicable to participants who separate from service when eligible for an early retirement benefit and participants who separate from service earlier. This provision is intended to cover the imposition of a requirement that application be made for benefits as well as the imposition of other conditions that are non-discriminatory.

These regulations supersede temporary income tax regulations § 11.401(a)-14, published on October 8, 1975 in the Federal Register (40 F.R. 47107).

Adoption of amendments to the regulations

On October 8, 1975, notice of proposed rule making with respect to amendments of the Income Tax Regulations (26 CFR Part 1) under section 401(a)(14) of the Internal Revenue Code of 1954, as added by section 1021(d) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, 88 Stat. 937), was published in the Federal Register (40 F.R. 47138). A public hearing regarding this notice of proposed rule making was held on February 26, 1976, and, after consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, certain revisions to the regulations as proposed have been made. Thus, the Income Tax Regulations (26 CFR Part 1) are amended by adding the new section, set forth below, immediately after § 1.401-14. This new section supersedes § 11.401(a)-14 of the Temporary Income Tax Regulations Under the Employee Retirement Income Security Act of 1974 (26 CFR Part 11).

§ 1.401(a)-14 Commencement of benefits under qualified trusts.

(a) *In general.* Under section 401 (a)(14), a trust to which section 411 applies (without regard to section 411 (e)(2)) is not qualified under section 401 unless the plan of which such trust is a part provides that the payment of benefits under the plan to the participant will begin not later than the 60th day after the close of the plan year in which the latest of the following events occurs—

(1) The attainment by the participant of age 65, or, if earlier, the normal retirement age specified under the plan,

(2) The 10th anniversary of the date on which the participant commenced participation in the plan.

(3) The termination of the participant's service with the employer, or

(4) The date specified in an election made pursuant to paragraph (b) of this section.

Notwithstanding the preceding sentence, a plan may require that a participant file a claim for benefits before payment of benefits will commence.

(b) *Election of later date*—(1) *General rule.* A plan may permit a participant to elect that the payment to him of any benefit under a plan will commence at a date later than the dates specified under subparagraphs (1), (2), and (3) of paragraph (a) of this section.

(2) *Manner of election.* A plan permitting an election under this paragraph shall require that such election must be made by submitting to the plan administrator a written statement, signed by the participant, which describes the benefit and the date on which the payment of such benefit shall commence.

(3) *Restriction.* An election may not be made pursuant to a plan provision permitted by this paragraph if the exercise of such election will cause benefits payable under the plan with respect to the participant in the event of his death to be more than "incidental" within the meaning of paragraph (b)(1)(i) of § 1.401-1.

(c) *Special early retirement rule*—(1) *Separation prior to early retirement age.* A trust forming part of a plan which provides for the payment of an early retirement benefit is not qualified under section 401 unless, upon satisfaction of the age requirement for such early retirement benefit, a participant who:

(i) Satisfied the service requirements for such early retirement benefit, but

(ii) Separated from service (with any nonforfeitable right to an accrued benefit) before satisfying such age requirement,

is entitled to receive not less than the reduced normal retirement benefit described in subparagraph (2) of this paragraph. A plan may establish reasonable conditions for payments of early retirement benefits (including for example, a requirement that a claim for benefits be made) if the conditions are equally applicable to participants who separate from service when eligible for an early retirement benefit and participants who separate from service earlier.

(2) *Reduced normal retirement benefit.* For purposes of this section, the reduced normal retirement benefit is the benefit to which the participant would have been entitled under the plan at normal retirement age, reduced in accordance with reasonable actuarial assumptions.

(3) *Separation prior to effective date of this section.* The provisions of this paragraph shall not apply in the case of a plan participant who separates from service before attainment of early retirement age and prior to the effective date of this section set forth in paragraph (e) of this section.

(4) *Illustration.* The provisions of this paragraph may be illustrated by the following example:

Example. The X Corporation Defined Benefit Plan provides that a normal retirement benefit will be payable to a participant upon attainment of age 65. The plan also provides that an actuarially reduced retirement benefit will be payable, upon application, to any participant who has completed 10 years of service with the X Corporation and attained age 60. When he is 55 years of age and has completed 10 years of service with X Corporation, A, a participant in the plan, leaves the service of X Corporation and does not return. The plan will not be qualified under section 401 unless, upon attainment of age 60 and application for benefits, A is entitled to receive a reduced normal retirement benefit described in subparagraph (2) of this paragraph.

(d) *Retroactive payment rule.* If the amount of the payment required to commence on the date determined under this section cannot be ascertained by such date, or if it is not possible to make such payment on such date because the plan administrator has been unable to locate the participant after making reasonable efforts to do so, a payment retroactive to such date may be made no later than 60 days after the earliest date on which the amount of such payment can be ascertained under the plan or the date on which the participant is located (whichever is applicable).

(e) *Effective date.* This section shall apply to a plan for those plan years to which section 411 of the Code applies without regard to section 411(e)(2).

(This Treasury decision is issued under the authority contained in sections 401(a)(14) and 7805 of the Internal Revenue Code of 1954 (88 Stat. 937, 68A Stat. 917; 26 U.S.C. 401 (a)(14), 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved September 23, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury

(Filed by the Office of the Federal Register on September 23, 1976; 4:42 p.m., and published in the issue of the Federal Register for September 28, 1976, 41 F.R. 42651)

26 CFR 1.401(a)-15: Requirement that plan benefits are not decreased on account of certain social security increases.

T.D. 7434

TITLE 26.—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Requirement that benefits under a qualified plan are not decreased on account of certain social security increases

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF
INTERNAL REVENUE,
Washington, D.C., 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

By a notice of proposed rule making appearing in the Federal Register on October 15, 1975 (40 F.R. 48361), amendments to the Income Tax Regulations (26 CFR Part 1) were proposed in order to prescribe regulations under section 401(a)(15) of the Internal Revenue Code of 1954, as added by section 1021(e) of the Employee Retirement Income Security Act of 1974 (the "Act") (88 Stat. 938) [Pub. L. 93-406, 1974-3 C.B.].

Section 401(a) of the Internal Revenue Code of 1954 provides certain requirements for qualification of pension, profit-sharing, and stock bonus plans. Under paragraph (15) of section 401(a), as added by the Act, the benefits of a participant in a qualified plan may not be reduced by reason of an increase in benefit levels payable, or in the wage base, under title II of the Social Security Act if the increase takes place after the later of (1) September 2, 1974, or (2) the earlier of the date plan benefits are first received by the participant (or his beneficiary) or the date of the participant's separation from service.

Section 401(a)(15) and the regulations thereunder apply with respect to benefits (1) which are being received under the plan by a participant or beneficiary or (2) to which a participant who is separated from service has nonforfeitable rights.

After consideration of comments submitted in writing and made orally at a public hearing on February 26, 1976, the text of proposed regulations § 1.401(a)-15 has been revised to clarify the rules set forth therein.

First, paragraph (a), as set forth in the proposed regulations, has been modified to make it clear that this section of the regulations applies only to plans under which determination of benefits is related, in some way, to the wage base or to benefits payable under title II of the Social Security Act.

Second, subparagraph (2)(ii) has been revised to clarify that, in the case where a participant, who has separated from service, subsequently returns and resumes participation in a plan to which section 401(a)(15) applies, a benefit to which such participant has a nonforfeitable right under such plan may not be decreased on account of any social security increases occuring during such separation which would decrease such benefit to a level below the level of benefits to which he would have been entitled had he not returned to service.

Finally, an example has been added to paragraph (c) of the regulations to illustrate that a plan to which section 401(a)(15) of the Code applies satisfies the requirements of that section, where such plan provides that, in the case of a person who retires and who is entitled to receive a deferred vested benefit upon reaching normal retirement age, the Social Security offset is to be computed using a modification of the method described in section 11.012 of Rev. Rul. 71-446, 1971-2 C.B. 187.

The proposed regulations, as revised, supersede temporary income tax regulations § 11.401(a)-15, which was published on October 15, 1975 in the Federal Register (40 F.R. 48345).

Adoption of amendments to the regulations

On October 15, 1975, notice of proposed rule making with respect to amendments of the Income Tax Regulations (26 CFR Part 1) under section 401(a)(15) of the Internal Revenue Code of 1954, as added by section 1021(e) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, [1974-3 C.B.] 88 Stat. 938), was published in the Federal Register (40 F.R. 48361). A public hearing with regard to this notice of proposed rule making was held on February 26, 1976, and after consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, certain revisions to the proposed regulations have been made. Thus, the Income Tax Regulations (26 CFR Part 1) are amended by adding the new section set forth below immediately after § 1.401(a)-14. The regulation set forth below supersedes § 11.401(a)-15 of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 (26 CFR Part 11) [T.D. 7382, 1975-2 C.B. 137].

§ 1.401(a)-15 Requirement that plan benefits are not decreased on account of certain social security increases.

(a) *In general.* Under section 401(a)(15), a trust which is part of a plan to which section 411 applies (without regard to section 411(e)(2)) is not qualified under section 401 unless, under the plan of which such trust is a part:

(1) *Benefit being received by participant or beneficiary.* A benefit (including a death or disability benefit) being received under the plan by a participant or beneficiary (other than a participant to whom subparagraph (2)(ii) of this paragraph applies, or a beneficiary of such a participant) is

not decreased by reason of any post-separation social security benefit increase effective after the later of—

(i) September 2, 1974, or

(ii) The date of first receipt of any retirement benefit, death benefit, or disability benefit under the plan by the participant or by a beneficiary of the participant (whichever receipt occurs first).

(2) *Benefit to which participant separated from service has nonforfeitable right.* In the case of a benefit to which a participant has a nonforfeitable right under such plan—

(i) If such participant is separated from service and does not subsequently return to service and resume participation in the plan, such benefit is not decreased by reason of any post-separation social security benefit increase effective after the later of September 2, 1974, or separation from service, or

(ii) If such participant is separated from service and subsequently returns to service and resumes participation in the plan, such benefit is not decreased by reason of any post-separation social security benefit increase effective after September 2, 1974, which occurs during separation from service and which would decrease such benefit to a level below the level of benefits to which he would have been entitled had he not returned to service after his separation.

(b) *Post-separation social security benefit increase.* For purposes of this section, the term "post-separation social security benefit increase" means, with respect to a participant or a beneficiary of the participant, an increase in a benefit level or wage base under title II of the Social Security Act (whether such increase is a result of an amendment of such title II or is a result of the application of the provisions of such title II) occurring after the earlier of such participant's separation from service or commencement of benefits under the plan.

(c) *Illustration.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). A plan to which section 401(a)(15) applies provides an annual benefit at the normal retirement age, 65, in the form of a stated benefit formula amount less a specified percentage of the primary insurance amount payable under title II of the Social Security Act. The plan provides no early retirement benefits. In the case of a participant who separates from service before age 65 with a nonforfeitable right to a benefit under the plan, the plan defines the primary insurance amount as the amount which the participant is entitled to receive under title II of the Social Security Act at age 65, multiplied by the ratio of the number of years of service with the employer to the number of years of service the participant would have had if he had worked for the employer until age 65. The plan does not satisfy the requirements of section 401(a)(15), because social security increases that occur after a participant's separation from service will reduce the benefit the participant will receive under the plan.

Example (2). A plan to which section 401(a)(15) applies provides an annual benefit at the normal retirement age, 65, in the form of a stated benefit formula amount less a specified percentage of the primary insurance amount payable under title II of the Social Security Act. The plan provides no early retirement benefits. In the case of a participant who separates from service before age 65 with a nonforfeitable right to a benefit under the plan, the plan defines the primary insurance amount as the amount which the participant is entitled to receive under title II of the Social Security Act at age 65 based upon the assumption that he will continue to receive until reaching age 65 compensation which would be treated as wages for purposes of the Social Security Act at the same rate as he received such compensation at the time he separated from service, but determined without regard to any post-separation social security benefit increase, multiplied by the ratio of the number of years of service with the employer to the number of years of service the participant would have had if he had worked for the employer until age 65. The plan satisfies the requirements of section 401(a)(15), because social security increases that occur after a participant's separation from service will not reduce the benefit the participant will receive under the plan.

(d) *Other Federal or State laws.* To the extent applicable, the rules discussed in this section will govern classifications under a plan supplementing the benefits provided by other Federal or State laws, such as the Railroad Retirement Act of 1937. See section 206(b) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, [1974-3 C.B.] 88 Stat. 864).

(e) *Effect on prior law.* Nothing in this section shall be construed as amending or modifying the rules applicable to post-separation social security increases prior to September 2, 1974. See paragraph (e) of § 1.401-3.

(f) *Effective date.* Section 401(a)(15) and this section shall apply to a plan only with respect to plan years to which section 411 (relating to minimum vesting standards) is applicable to the plan without regard to section 411(e)(2).

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved Sept. 20, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 27, 1976, 8:45 a.m., and published in the issue of the Federal Register for September 28, 1976, 41 F.R. 42649)

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26 CFR 1.401(b): Statutory provisions; qualified pension, profit-sharing, and stock bonus plans; certain retroactive changes in plans.

T.D. 7437

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Certain retroactive amendments of employee plans.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF
INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

By a notice of proposed rule making appearing in the Federal Register on October 7, 1975 (40 F.R. 46314), amendments to the Income Tax Regulations (26 CFR Part 1) under section 401(b) of the Internal Revenue Code of 1954, as amended by section 1023 of the Employee Retirement Income Security Act of 1974 (the "Act") (Pub. L. 93-406, 88 Stat. 943) [1974-3 C.B. 1], were proposed in order to provide rules for certain retroactive amendments of employee plans.

Section 401(b), as amended by the Act, provides that certain plan amendments adopted to correct certain "disqualifying provisions" of plans may be given retroactive effect for purposes of determining the qualification of the plan under section 401(a), if such amendments are adopted by the due date (including extensions) of the employer's income tax return for the taxable year in which the plan or amendment was adopted, or a later time designated by the Secretary or his delegate.

A public hearing regarding the proposed regulations was held on February 26, 1976, and, after consideration of comments made orally at this hearing and those submitted in writing, the text of the proposed regulations has been revised in several respects.

Paragraph (a) of § 1.401(b)-1 requires a curative retroactive amendment under which all provisions of the plan which are necessary to satisfy all requirements of sections 401(a), 403(a), or 405(a) are in effect for all purposes for the whole of the remedial amendment period. Under some facts and circumstances, it may not be possible to amend a plan retroactively so that all provisions of the plan which are necessary to satisfy the requirements of section 401(a) are in fact made effective for the whole remedial amendment period. If it is not possible, the requirements of this section will not be satisfied even if the employer adopts a retroactive plan amendment which, in form, appears to satisfy such requirements. Paragraph (a) also provides that section 401(b) may not be used as the basis for retroactively creating a plan for a taxable year of an employer prior to the taxable year in which the plan was adopted.

Paragraph (c) of § 1.401(b)-1 has been modified to provide a special rule for determining the end of the remedial amendment period for plans maintained by more than one employer. In such a case, the remedial amendment period ends on the last day of the 10th month following the end of the plan year containing the later of the date the remedial amendment period begins or the date the disqualifying provision became effective. Paragraph (c) has also been modified to provide that in all cases, rather than only in the case of a disqualifying provision arising because of the qualification changes brought about by the Act, the remedial amendment period does not end before the last day of the plan year, if that date is later than the time for filing the employer's tax return.

Paragraph (c) has also been modified to provide generally that remedial amendment periods arising on or after September 2, 1974, the date of enactment of the Act, do not end before December 31, 1976. This provision is applicable only with respect to plans subject to the vesting requirements of section 411, and is therefore not applicable to plans described in section 411(e)(1), such as governmental plans and church plans which do not elect under Code section 410(d) to have various ERISA provisions apply.

Special rules have been provided in cases in which an employer adopts a master or prototype or district approved pattern plan. In such cases, paragraph (d) of § 1.401(b)-1 provides that the employer is generally allowed six months following action by the Service on the opinion letter request by the master or prototype plan sponsor or notification letter request by the sponsor of a pattern plan.

Paragraph (d) has also been modified with respect to an employer's request for a determination letter regarding the qualified status of the plan. In that case, paragraph (d)(3) of § 1.401(b)-1 provides that the remedial amendment period shall be extended until the expiration of 91 days following final resolution of the request, whether or not the request was made by the end of the employer's taxable year. In the case of employers who have received a final determination prior to the time this regulation is published, paragraph (d)(4) allows 150 days to prevent undue hardship.

A new provision has been added to paragraph (d) to provide rules with respect to remedial amendment periods which began prior to September 2, 1974. In those cases, in addition to the rules for extension of the remedial amendment period found elsewhere in the section, the remedial period will not end until December 31, 1976, if, while an application for a determination letter is pending, or promptly upon receiving final notification from the Service of defects in the plan, the employer adopted an amendment which would have cured the plan if the new rules of § 1.401(b)-1 had been in effect at that time.

Finally, a new paragraph (e) has been added to provide for an additional extension of the remedial amendment period at the discretion of the Internal Revenue Service. This authority may be exercised in the case of substantial hardship to the employer, or in the best interest of plan participants, and if not adverse to the interests of the Government. The request must be made before the end of the remedial amendment period or at

a later time that the Service considers reasonable under the circumstances. The mere absence of final regulations with respect to issues covered under the Special Reliance Procedure announced by the Service in Technical Information Release 1416 on November 5, 1975, and extended by Internal Revenue Service News Release IR-1616 on May 14, 1976, shall not be deemed to satisfy the requirements for a discretionary extension under § 1.401(b)-1(e).

Adoption of amendments to the regulations

On October 7, 1975, notice of proposed rule making with respect to amendments of the Income Tax Regulations (26 CFR Part 1) under section 401(b) of the Internal Revenue Code of 1954, as added by section 1023 of the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, 88 Stat. 943) [1974-3 C.B. 1], was published in the Federal Register (40 F.R. 46314). A public hearing regarding this notice of proposed rule making was held on February 26, 1976, and, after consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, certain revisions to the regulations as proposed have been made. Thus, the Income Tax Regulations (26 CFR Part 1) are amended as set forth below. Section 1.401(b)-1 of these regulations supersedes § 11.401(b)-1 of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 (26 CFR Part 11).

Paragraph 1. Section 1.401-5 is amended by revising the section title and adding at the end thereof the following new sentence:

§ 1.401-5 Period for which requirements of section 401(a)(3), (4), (5), and (6) are applicable with respect to plans put into effect before September 2, 1974.

* * * * *

This section shall not apply to any pension, profit-sharing, stock bonus, or annuity plan put into effect after September 1, 1974, and shall not apply with respect to any disqualifying provision to which § 1.401(b)-1 applies.

Par. 2. The following new sections are inserted immediately after § 1.401(a)-15:

§ 1.401(b) Statutory provisions; qualified pension, profit-sharing, and stock bonus plans; certain retroactive changes in plan.

Sec. 401. *Qualified pension, profit-sharing, and stock bonus plans.* * * *

(b) *Certain retroactive changes in plan.* A stock bonus, pension, profit-sharing, or annuity plan shall be considered as satisfying the requirements of subsection (a) for the period beginning with the date on which it was put into effect, or for the period beginning with the earlier of the date on which there was adopted or put into effect any amendment which caused the plan to fail to satisfy such requirements, and ending with the time prescribed by law for filing the return of the employer for his taxable year in which such plan or amendment was adopted (including extensions thereof) or such later time as the Secretary or his delegate may designate, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes for the whole of such period.

* * * * *

[Sec. 401(b) as amended by sec. 1023, Employee Retirement Income Security Act 1974 (Pub. L. 93-406, 88 Stat. 943) [1974-3 C.B. 1]]

§ 1.401(b)-1 Certain retroactive changes in plan.

(a) *General rule.* Under section 401(b) a stock bonus, pension profit-sharing, annuity, or bond purchase plan which does not satisfy the requirements of section 401(a) on any day solely as a result of a disqualifying provision (as defined in paragraph (b) of this section) shall be considered to have satisfied such requirements on such date if, on or before the last day of the remedial amendment period (as determined under paragraphs (c), (d) and (e) of this section) with respect to such disqualifying provision, all provisions of the plan which are necessary to satisfy all requirements of sections 401(a), 403(a), or 405(a) are in effect and have been made effective for all purposes for the whole of such period. Under some facts and circumstances, it may not be possible to amend a plan retroactively so that all provisions of the plan which are necessary to satisfy the requirements of section 401(a) are in fact made effective for the whole remedial amendment period. If it is not possible, the requirements of this section will not be satisfied even if the employer adopts a retroactive plan amendment which, in form, appears to satisfy such requirements. Section 401(b) does not permit a plan to be made retroactively effective, for qualification purposes, for a taxable year prior to the taxable year of the employer in which the plan was adopted by such employer.

(b) *Disqualifying provisions.* For purposes of this section, with respect to a plan described in paragraph (a) of this section, the term "disqualifying provision" means—

(1) A provision of a new plan, the absence of a provision from a new plan, or an amendment to an existing plan, which causes such plan to fail to satisfy the requirements of the Code applicable to qualification of such plan as of the date such plan or amendment is first made effective, or

(2) A plan provision which results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in such requirements effected by the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, 88 Stat. 829), hereafter referred to as "ERISA." For purposes of this subparagraph, a disqualifying provision includes the absence from a plan of a provision required by such change if the plan was in effect on the date such change became effective with respect to such plan.

(c) *Remedial amendment period.* (1) The remedial amendment period with respect to a disqualifying provision begins—

(i) In the case of a provision of, or absence of a provision from, a new plan, described in paragraph (b)(1) of this section, the date the plan is put into effect,

(ii) In the case of an amendment to an existing plan, described in paragraph (b)(1) of this section, the date the plan amendment is adopted or put into effect (whichever is earlier), or

(iii) In the case of a disqualifying provision described in paragraph (b)(2) of this section, the date on which the change effected by ERISA, described in paragraph (b)(2) of this section, became effective with respect to such plan.

(2) Unless further extended as provided by paragraph (d) of this section, the remedial amendment period ends with the latest of—

(i) In the case of a plan maintained by one employer, the time prescribed by law, including extensions, for filing the income tax return (or partnership return of income) of the employer for the employer's taxable year in which falls the latest of—

(A) The date on which the remedial amendment period begins,

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date on which a plan amendment described in paragraph (b)(1) of this section is made effective,

(ii) In the case of a plan maintained by one employer, the last day of the plan year within which falls the latest of—

(A) The date on which the remedial amendment period begins,

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date on which a plan amendment described in paragraph (b)(1) of this section is made effective,

(iii) In the case of a plan maintained by more than one employer, the last day of the tenth month following the last day of the plan year in which falls the latest of—

(A) The date on which the remedial amendment period begins,

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date of which a plan amendment described in paragraph (b)(1) of this section is made effective, or

(iv) December 31, 1976, but only in the case of a plan to which section 411 (relating to minimum vesting standards) applies without regard to section 411(e)(2), and only in the case of a remedial amendment period which began on or after September 2, 1974.

For purposes of this paragraph (c)(2) of this section, a master or prototype plan shall not be considered to be a plan maintained by more than one employer, and whether or not a plan is maintained by more than one employer shall be determined without regard to section 414(b) and (c) except that if a plan is maintained solely by an affiliated group of corporations (within the meaning of section 1504) which files a consolidated income tax return pursuant to section 1501 for a taxable year within which falls the latest of the dates described in paragraph (c)(2)(i) of this section, such plan shall be deemed to be maintained by one employer.

(d) *Extensions of remedial amendment period*—(1) *Opinion letter request by sponsoring organization of master or prototype plan.* In the case of an employer who has adopted a master or prototype plan, a remedial amendment period that began on or after September 2, 1974, shall not end prior to the later of—

(i) June 30, 1977, or

(ii) The last day of the month that is six months after the month in which—

(A) The opinion letter with respect to the request of the sponsoring organization is issued by the Internal Revenue Service,

(B) Such request is withdrawn, or

(C) Such request is otherwise disposed of by the Internal Revenue Service. The rules contained in this subparagraph apply only if the sponsoring organization of such master or prototype plan has, after September 2, 1974, and on or before December 31, 1976, filed a request for an opinion letter with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan). The provisions of this subparagraph (d)(1) apply to a master or prototype plan adopted to replace another plan even though the remedial amendment period applicable to the replaced plan has expired at the time of adoption of the replacement plan.

(2) *Notification letter request by law firm sponsor of district-approved pattern plan.* In the case of an employer who has adopted a pattern plan, a remedial amendment period that began on or after September 2, 1974, shall not end prior to the later of—

(i) June 30, 1977, or

(ii) The last day of the month that is six months after the month in which—

(A) The notification letter with respect to the request of the sponsoring law firm is issued by the Internal Revenue Service,

(B) Such request is withdrawn, or

(C) Such request is otherwise disposed of by the Internal Revenue Service. The rules contained in this subparagraph shall apply only if the sponsoring law firm of such pattern plan has, on or before December 31, 1976, filed a request for a notification letter with the Internal Revenue Service with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan). The provisions of this subparagraph (d)(2) apply to a pattern plan adopted to replace another plan even though the remedial amendment period applica-

ble to the replaced plan has expired at the time of the adoption of the replacement plan.

(3) *Determination letter request by employer or plan administrator.* If on or before the end of a remedial amendment period determined without regard to this paragraph (d), or in a case to which paragraph (d)(1) or (2) of this section applies, on or before the 90th day following the later of the dates described in paragraph (d)(1) or (2) of this section, the employer or plan administrator files a request pursuant to § 601.201(o) of this chapter (Statement of Procedural Rules) for a determination letter with respect to the initial or continuing qualification of the plan, or a trust which is part of such plan, such remedial amendment period shall be extended until the expiration of 91 days after—

(i) The date on which notice of the final determination with respect to such request for a determination letter is issued by the Internal Revenue Service, such request is withdrawn, or such request is otherwise finally disposed of by the Internal Revenue Service, or

(ii) If a petition is timely filed with the United States Tax Court for a declaratory judgment under section 7476 with respect to the final determination (or the failure of the Internal Revenue Service to make a final determination) in response to such request, the date on which the decision of the United States Tax Court in such proceeding becomes final.

(4) *Transitional rule.* In the case of a request for a determination letter described in and filed within the time prescribed in paragraph (d)(3) of this section with respect to which a final determination is issued by the Internal Revenue Service on or before September 28, 1976, the remedial amendment period described in paragraph (c) of this section shall not end prior to the expiration of 150 days beginning on the date of such final determination by the Internal Revenue Service.

(5) *Disqualifying provision prior to September 2, 1974.* If the remedial amendment period with respect to a disqualifying provision described in paragraph (b)(1) of this section began prior to September 2, 1974, and the provisions of subdivisions (i), (ii) and (iii) of this subparagraph are satisfied, the remedial amendment period described in paragraph (c) shall not end prior to December 31, 1976. This subparagraph shall apply only if—

(i) A request pursuant to § 601.201 of this chapter for a determination letter with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan) was filed not later than the later of—

(A) The time prescribed by law, including extensions, for filing the income tax return (or partnership return of income) of the employer for the employer's taxable year in which falls the date on which the remedial amendment period began, or

(B) The date 6 months after the close of such taxable year,

(ii) The employer, either—

(A) While such request for a determination letter is or was under consideration by the Internal Revenue Service or,

(B) Promptly after the date on which notice of the final determination with respect to such request for a determination letter is issued by the Internal Revenue Service, such request is withdrawn, or such request is otherwise finally disposed of by the Internal Revenue Service,

adopts or adopted either a plan amendment retroactive to the date on which the remedial amendment period began, or a prospective plan amendment, and

(iii) The amendment described in paragraph (d)(5)(ii) of this section would have resulted in the plan's satisfying the requirements of section 401(a) of the Code from the beginning of the remedial amendment period to the date such amendment was made if this section had been in effect during such period, and in the case of a prospective amendment, if such amendment had been made retroactive to such beginning date.

(e) *Discretionary extensions.* At his discretion, the Commissioner may extend the remedial amendment period or may allow a particular plan to be amended after the expiration of its remedial amendment period and any applicable extension of such period. In determining whether such an extension will be granted, the Commissioner shall consider, among other factors, whether substantial hardship to the employer would result if such an extension were not granted, whether such an extension is in the best interest of plan participants, and whether the granting of the extension is adverse to the interests of the Government. The mere absence of final regulations with respect to issues covered under the Special Reliance Procedure announced by the Internal Revenue Service in Technical Information Release 1416 on November 5, 1975, and as extended by Internal Revenue Service News Release IR-1616 on May 14, 1976, shall not be deemed to satisfy the criteria of this paragraph. With regard to a particular plan, a request for extension of time pursuant to this paragraph shall be submitted prior to the expiration of the remedial amendment period determined without regard to this paragraph, or within such time thereafter as the Internal Revenue Service may consider reasonable under the circumstances. The request should be submitted to the appropriate District Director, determined under § 601.201(o)(3)(xii) of this chapter (Statement of Procedural Rules). This subparagraph applies to disqualifying provisions that were adopted or became effective prior to September 2, 1974, as well as disqualifying provisions

adopted or made effective on or after September 2, 1974.

(This Treasury decision is issued under the authority contained in sections 401(b) and 7805 of the Internal Revenue Code of 1954 (88 Stat. 943, 68A Stat. 917; 26 U.S.C. 401(b), 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved September 23, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 23, 1976; 4:42 p.m., and published in the issue of the Federal Register for September 28, 1976, 41 F.R. 42652)

Section 403.—Taxation of Employee Annuities

26 CFR 1.403(a)-1: Taxability of beneficiary under a qualified annuity plan.

Procedure for applying interim rules governing qualified employee plans pending the issuance of final rules and regulations. See Rev. Proc. 76-31, page 649.

Section 405.—Qualified Bond Purchase Plans

26 CFR 1.405-1: Qualified bond purchase plans.

Procedure for applying interim rules governing qualified employee plans pending the issuance of final rules and regulations. See Rev. Proc. 76-31, page 649.

Section 408.—Individual Retirement Accounts

Procedures to be followed by employers and employees associations requesting rulings on or after October 4, 1976 on individual retirement accounts. See Rev. Proc. 76-32, page 654.

Subpart B.—Special Rules

Section 410.—Minimum Participation Standards

Defined contribution plan that fails to require allocation of employer contributions to account of every participant who has more than 1,000 hours of service in an allocation period. See Rev. Rul. 76-250, below.

Section 411.—Minimum Vesting Standards

(Also Sections 401, 410; 1.401-4.)

Defined contribution plan; minimum vesting requirements. A defined contribution plan that fails to provide an unconditional allocation to a participant who has completed 1,000 hours of service in a computation period will not thereby violate the minimum participation and vesting requirements of sections 410 and 411 of the Code, but such failure may result in discrimination under section 401(a)(4).

Rev. Rul. 76-250 [1]

Advice has been requested as to (1) whether a defined contribution plan may satisfy the requirements of sections 410 and 411 of the Internal Revenue Code of 1954 if it fails to provide an allocation to any participant with respect to a computation period in which such participant completes at least 1,000 hours of service, and (2) whether the failure to provide such an allocation could cause discrimination within the meaning of section 401(a)(4).

Section 411 of the Code requires that a plan participant must be vested in a percentage of his accrued benefit that is not less than that specified in section 411(a). Section 411(b)(1) requires ratable increases in an employee's accrued benefit based on his completion of years of participation as defined in section 411(b)(3). However, section 411(b)(1) relates to defined benefit plans only. There is no similar requirement for defined contribution plans; in contrast, section 411(a)(7) provides that a participant's accrued benefit under a defined contribution plan is the balance of the employee's account.

A defined contribution plan, therefore, will not fail to satisfy the requirements of sections 410 and 411 of the Code merely because it does not unconditionally provide for an allocation to a participant with respect to a computation period in which he completes 1,000 hours of service. Thus, for example, a defined contribution plan could, without violating the minimum participation or vesting standards of sections 410 and 411 of the Code, require that a participant be employed as of the last day of a computation period in order to receive an allocation.

A participant who completes 1,000 hours of service in a particular year does, however, not cease to be a participant for such year, for the purposes of the minimum participation standards of section 410 of the Code, merely because he separates from service before the end of that year. Section 401(a)(4) of the Code provides that contributions or benefits shall not discriminate in favor of officers, shareholders, or highly compensated employees. In measuring discrimination under section 401(a)(4) of the Code, discrimination is considered only with respect to plan participants. See Rev. Rul. 68-301, 1968-1 C.B. 161.

A plan participant who is denied an allocation for a computation period in which he completed 1,000 hours of service is considered to have received an allocation of zero dollars for the period involved. If such zero dollar allocation results in discrimination in favor of employees who are officers, shareholders, or highly compensated, then such plan will not satisfy the requirements of section 401(a)(4) of the Code.

[1] Also released as IR-1623, dated June 11, 1976.

26 CFR 11.411(a)-8: Changes in vesting schedule.

An interpretation and application, in the case of certain interim plan provisions, of section 411(a)(10) of the Code with respect to employers or other plan sponsors

utilizing the Special Reliance Procedure. See Rev. Rul. 76-378, page 112.

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26 CFR 11.411(b)-1: Accrued benefit requirements.

Guidelines for determining whether the accrued benefits of a defined benefit plan that are offset by the benefits of a defined contribution plan satisfy accrued benefit requirements. See Rev. Rul. 76-259, page 111.

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26 CFR 11.411(d)-3: Other special rules; prohibition against accrued benefit decrease.

An interpretation and application, in the case of certain interim plan provisions, of section 411(d)(6) of the Code, with respect to employers or other plan sponsors utilizing the Special Reliance Procedure. See Rev. Rul. 76-378, page 112.

Section 412.—Minimum Funding Standards

22 CFR 11.412(c)-12: Extension of time to make contributions to satisfy requirements of section 412.

T.D. 7439

TITLE 26.—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER A, PART 11.—TEMPORARY INCOME TAX REGULATIONS UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Extension of time to make contributions to satisfy requirements of section 412 of the Internal Revenue Code of 1954

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

This document contains temporary income tax regulations (26 CFR Part 11) under section 412(c)(10) of the Internal Revenue Code of 1954, as added by section 1013(a) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, 88 Stat. 917 [1974-3 C.B.]) (hereinafter referred to as the "Act").

Section 412 of the Code sets forth the minimum funding standards with respect to certain employee plans described therein. Section 412(c)(10) of the Code provides that for purposes of section 412 a contribution for a plan year made after the end of such year but not later than two and one-half months after the last day of such plan year shall be deemed to have been made on the last day of the plan year. Section 412(c)(10) further provides that under regulations the two and one-half month period may be extended for not more than six months. These temporary regulations provide rules for extending the period for such six months.

Adoption of regulations

In order to prescribe temporary income tax regulations (26 CFR Part 11) under section 412(c)(10) of the Internal Revenue Code of 1954, as added to such Code by section 1013(a) of the Employee Retirement Income Security Act (Pub. L. 93-406, 88 Stat. 917 [1974-3 C.B.]) the following temporary regulations are hereby adopted:

Paragraph 1. The following new section is inserted immediately after §11.412(c)-11:

§11.412(c)-12 Extension of time to make contributions to satisfy requirements of section 412.

(a) *In general.* Section 412(c)(10) of the Internal Revenue Code of 1954 provides that for purposes of section 412 a contribution for a plan year made after the end of such plan year but not later than two and one-half months after the last day of such plan year shall be deemed to have been made on such last day. Section 412(c)(10) further provides that the two and one-half month period may be extended for not more than six months under regulations.

(b) *Six month extension of two and one-half month period*—(1) For purposes of section 412 a contribution for a plan year to which section 412 applies that is made not more than eight and one-half months after the end of such plan year shall be deemed to have been made on the last day of such year.

(2) The rules of this section relating to the time a contribution to a plan is deemed made for purposes of the minimum funding standard under section 412 are independent from the rules contained in section 404(a)(6) relating to the time a contribution to a plan is deemed made for purposes of claiming a deduction for such contribution under section 404.

Because of the need for immediate guidance with respect to the provisions contained in this Treasury decision, it is found impracticable to issue it with notice and public procedure thereon under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

(This Treasury decision is issued under the authority contained in sections 412(c)(10) and 7805 of the Internal Revenue Code of 1954 (88 Stat. 917; 26 U.S.C. 412(c)(10) and 68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved October 18, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 21, 1976, 8:45 a.m., and published in the issue of the Federal Register for October 22, 1976, 41 F.R. 46597.)

Section 415.—Limitations on Benefits and Contributions Under Qualified Plans

Rev. Rul. 76-318 [1]

Revenue Ruling 75-481, 1975-2

[1] Also released as IR-1647, dated July 28, 1976.

C.B. 188, provides, in part, that in lieu of using a calendar year as the limitation year for an employee plan under section 415 of the Internal Revenue Code of 1954, an employer may elect to use any other twelve-month period. Paragraph (4) of section 2.01 of Rev. Rul. 75-481 provides a special rule if an employer changes the limitation year. Paragraph (3) of section 2.01 provides that an employer may elect a limitation year which is not a calendar year by written resolution, and that if the first such resolution is adopted prior to July 1, 1976, the election will not be deemed a change in the limitation year. The Internal Revenue Service has determined that an extension to December 31, 1976, is advisable. Accordingly, paragraph (3) is hereby modified to read as follows:

> The election described in paragraph (2) shall be made by the adoption of a written resolution by the employer. The first such resolution may be adopted at any time before January 1, 1977, and shall not be considered a change in the limitation year described in paragraph (4). A subsequent resolution or a resolution adopted after December 31, 1976, shall be considered to be a change of the limitation year as described in paragraph (4).

Revenue Ruling 75-481 is hereby modified.

Part II.—Certain Stock Options

Section 422.—Qualified Stock Options

26 CFR 1.422-2: Qualified stock options defined.

Employee stock option; ownership of stock. Common stock received by members of a corporation's board of directors in exchange for nonvoting preferred stock in accordance with a bylaw of the corporation, which provides that a person becoming a member of the board must exchange any preferred stock owned for an equal value of common stock and that such stock may not be sold, exchanged, transferred, or pledged by the member until such membership terminates, at which time the common stock must be exchanged for an equal value of preferred stock, is considered to be owned by the new board members for purposes of section 422(b)(7) of the Code.

Rev. Rul. 76-529

Advice has been requested whether, under the circumstances described below, stock acquired by members of a corporation's board of directors is considered stock owned for purposes of section 422(b)(7) of the Internal Revenue Code of 1954.

Under the corporation's articles of incorporation, its authorized capital stock consists of 20,000 shares of voting common stock and 500,000 shares of nonvoting noncumulative, nonredeemable, nonconvertible preferred stock. In accordance with a specific bylaw of the corporation, members of the board of directors are required to own sufficient common stock to represent, in the aggregate, a certain percentage of the corporation's outstanding common stock. A person becoming a member of the board is required to exchange any preferred stock that the person owns for voting common stock on a value for value basis. The common stock obtained in this manner is called "Executive Board" stock, and is subject to a written agreement under which the stock may not be sold, exchanged, or otherwise transferred, nor pledged or otherwise encumbered. Board members have the Executive Board stock recorded in their names and are entitled to vote the stock and to receive all dividends on it. Upon ceasing to be a member of the board of directors, the former member is obligated to surrender all Executive Board stock to the corporation in exchange for preferred stock on a value for value basis.

The corporation has a qualified stock option plan within the meaning of section 422 of the Code for the purchase of shares of its common stock. Members of the board of directors were among the employees who were granted stock options under this plan. However, because of their required ownership of Executive Board stock, some of the members of the board of directors had ownership of 5 percent or more of the corporation's voting common stock at the time they were granted the stock options.

The specific question is whether, in determining a board member's percentage of ownership of the corporation's voting common stock for purposes of section 422(b)(7) of the Code, the Executive Board stock acquired by the member is to be considered owned by the member.

Section 422(b)(7) of the Code requires that immediately after a qualified stock option is granted, the optionee not own stock possessing more than 5 to 10 percent (depending on the equity capital of the employer corporation) of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation.

The limitation contained in section 422(b)(7) of the Code was enacted because Congress did not intend to provide employees who are substantial stockholders of a corporation with any incentive to improve the business of the corporation when they already have a substantial stake in its successful operation. *H. R. Rep. No. 749,* 88th Cong. 1st Sess. 64 (1963), 1964-1 (Part 2) C.B. 125, 189.

Although the Executive Board stock cannot be sold or otherwise transferred or encumbered, the members who acquire such stock do possess important stock ownership rights, namely, the right to vote and receive dividends. Furthermore, the members, upon termination of their board membership, benefit from any increase in the value of the Executive Board stock at that time over the value paid for it, and, correspondingly, they assume the risk that the value of the Executive Board

stock at the time their board membership is terminated will be less than the value paid for it. See Rev. Rul. 64-312, 1964-2 C.B. 117, for a summary of the incidents of stock ownership in a situation where certain reaquisition rights are retained by an optionor corporation.

According, in determining the percentage of voting power of the members of the corporation's board of directors for purposes of section 422 (b)(7) of the Code, the Executive Board stock will be considered to be owned by the members of the board.

Compare Rev. Rul. 67-237, 1967-2 C.B. 167, where the shares of stock held by an employee in the capacity as a trustee of a voting trust are not considered owned by the employee for purposes of section 422(b)(7) of the Code, except to the extent that the employee has a beneficial interest in such stock.

Subchapter E.—Accounting Periods and Methods of Accounting
Part I.—Accounitng Periods

Section 441.—Period for Computation of Taxable Income

26 CFR 1.441-2: Election of year consisting of 52-53 weeks.
(Also Section 461; 1.461-1.)

Real property taxes; two accrual dates. An accrual method taxpayer who elected to use a 52-53-week taxable year and who has not treated such taxable year as consisting of 12 calendar months or elected to ratably accrue real property taxes may deduct the property taxes for 2 years in a 52-53-week taxable year that contained two accrual dates.

Rev. Rul. 76-482

Advice has been requested whether, under the circumstances described below, a taxpayer using the accrual method of accounting and who computes its income on the basis of a 52-53-week taxable year, may deduct, in a taxable year, two assessments for real property taxes under sections 441 and 461 of the Internal Revenue Code of 1954.

The taxpayer is a domestic corporation engaged in the furnishing of services. The taxpayer and its subsidiaries file their consolidated Federal income tax return on the basis of a 52-53-week taxable year using the accrual method of accounting. For the taxable year beginning December 29, 1969, and ending January 3, 1971, the taxpayer claimed on the consolidated income tax return a deduction for the accrual of real property taxes for a 2-year period, since that period contained two assessments (lien dates), January 1, 1970, and January 1, 1971. Real property taxes accrued on the lien dates. The taxpayer has never treated the deductions for real property taxes as though the 52-53-week taxable year was a taxable year consisting of 12 calendar months. The taxpayer did not deduct in a previous or subsequent period the real property taxes that were deducted on the consolidated income tax return for the year ending January 3, 1971, nor did the taxpayer elect to ratably accrue the real property taxes pursuant to section 461 (c)(1) of the Code.

Section 441(f) of the Code allows a taxpayer to elect to compute taxable income on the basis of a 52-53-week taxable year.

Section 1.441-2(d) of the Income Tax Regulations provides, in part, that the principles of section 461, relating to the taxable year for taking deductions, are generally applicable to 52-53-week taxable years. Thus, items of income and deductions are determined on the basis of a 52-53-week taxable year, except that such items may be determined as though the 52-53-week taxable year were a taxable year consisting of 12 calendar months if such practice is consistently followed by the taxpayer and if income is clearly reflected thereby.

Section 461(a) of the Code provides that the amount of deduction or credit allowed by subtitle A of the Code shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) of the regulations provides that under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

Accordingly, since the taxpayer determines the deductions for real property taxes on the basis of a 52-53-week taxable year, and not on a taxable year consisting of 12 calendar months, the taxpayer may deduct in the taxable year ended January 3, 1971, real property taxes accrued for two assessment dates, January 1, 1970, and January 1, 1971.

Section 442.—Change of Annual Accounting Period

26 CFR 1.442-1: Change of annual accounting period.
(Also Sections 1371, 6015; 1.1371-1, 1.6015(a)-1.)

Change in accounting period; small business corporation shareholder. A taxpayer whose principal source of income is dividends from an electing small business corporation will not be granted permission to change from a calendar year to a fiscal year ending March 31 to coincide with the availability of dividend information from the corporation and to enable the taxpayer to make a more accurate fourth quarter estimated tax payment.

Rev. Rul. 76-407

Advice has been requested whether, under the circumstances described below, a substantial business purpose has been shown for the granting of a change of annual accounting period under section 1.442-1(b) of the Income Tax Regulations.

The taxpayer, an individual, timely requested approval under section 1.442-1(b) of the regulations from the Commissioner of Internal Revenue to change the taxpayer's annual accounting period for Federal income tax purposes from a calendar year to a fiscal year ending March 31.

The taxpayer's income is principally derived from dividends of a corporation that qualifies as a "small business corporation" (subchapter S corporation) under section 1371(a) of the Internal Revenue Code of 1954. The corporation files its Federal income tax return on a calendar year basis, but does not disclose its profits and losses until its books and records are closed and audited. Consequently, the taxpayer is not informed of the dividend income from the corporation until March of the succeeding year.

The taxpayer makes a declaration of estimated tax pursuant to section 6015 of the Code, The taxpayer pays the estimated tax in four equal installments, the fourth installment being paid on January 15 of the succeeding taxable year.

Since the taxpayer is not informed of the amount of the dividend income earned from the corporation prior to January 15, the taxpayer's fourth quarter estimated payment has been based on the taxpayer's prior year's income. This procedure on occasion has resulted in overpayment or underpayment of estimated tax by the taxpayer.

Section 442 of the Code provides, in part, that if a taxpayer changes the taxpayer's annual accounting period, the new accounting period shall become the taxpayer's taxable year only if the change is approved by the Secretary of the Treasury or the Secretary's delegate.

Section 1.442-1(b)(1) of the regulations provides, in part, that in general a change of annual accounting period will be approved where the taxpayer establishes a substantial business purpose for making the change. In determining whether a taxpayer has established a substantial business purpose for making the change, consideration will be given to all the facts and circumstances relating to the change, including the tax consequences resulting therefrom.

In Rev. Rul. 60-182, 1960-1 C.B. 264, two individuals on April 1, 1959, organized a partnership with each individual acquiring a one-half interest in the partnership. The individuals filed their Federal income tax returns on a calendar year basis. The partnership, desiring to adopt a taxable year that was not the same as its principal partners, attempted to establish a business purpose for the adoption as required by section 1.706-1(b) of the regulations.

That Revenue Ruling holds that the fact that the adoption of a fiscal year ending March 31 as its taxable year by the partnership involved therein would result in reporting the operations for a full year in its first accounting period, and the further fact that the partners would have the advantage of having available at an earlier date information necessary to determine their individual partnership profits, is not a business purpose within the intendment of section 1.706-1(b) of the regulations.

Similarly, in the instant case, the fact that the change to a fiscal year ending March 31 would enable the taxpayer to obtain information concerning the amount of dividends earned from the subchapter S corporation that would assist the taxpayer in making a more accurate fourth quarter estimated payment is not a substantial business purpose within the meaning of section 1.442-1(b)(1) of the regulations.

Accordingly, the taxpayer is not granted approval to change the taxpayer's annual accounting period from a calendar year to a fiscal year ending March 31.

26 CFR 1.442-1: Change of annual accounting period.
(Also Section 1372; 1.1372-1.)

Change of accounting period; small business corporation. Simplification of the allocation of a small business corporation's income between the selling shareholder and the sole purchasing shareholder is not a substantial business purpose for the granting of a change of annual accounting period, under section 1.442-1(b) of the regulations, from a calendar year to a fiscal year.

Rev. Rul. 76-497

Advice has been requested whether, under the circumstances described below, a substantial business purpose has been shown by the taxpayer for the granting of a change of annual accounting period under section 1.442-1 (b) of the Income Tax Regulations.

The taxpayer is a corporation that elected to be treated as a small business corporation pursuant to section 1372 of the Internal Revenue Code of 1954.

On April 1, 1975, the sole shareholder of the taxpayer sold all of the stock of the taxpayer to the present shareholders. It is proposed that all of the taxpayer's income earned prior to March 31, 1975, be reported by the selling shareholder and that any income earned after March 31, 1975, be reported by the new shareholders in order to simplify the allocation of income or losses of a small business corporation in the taxable year that the stock of such corporation is sold.

The taxpayer timely requested approval under section 1.442-1(b) of the regulations from the Commissioner of Internal Revenue to change its annual accounting period for Federal income tax purposes from a calendar year to a fiscal year ending March 31.

Section 442 of the Code provides, in part, that if a taxpayer changes its annual accounting period, the new accounting period shall become the

taxpayer's taxable year only if the change is approved by the Secretary of the Treasury or the Secretary's delegate.

Section 1.442-1(b)(1) of the regulations provides, in part, that a change of annual accounting period will be approved where the taxpayer establishes a substantial business purpose for making the change. In determining whether a taxpayer has established a substantial business purpose for making the change, consideration will be given to all the facts and circumstances relating to the change, including the tax consequences resulting therefrom. Among the nontax factors that will be considered in determining whether a substantial business purpose has been established is the effect of the change on the taxpayer's annual cycle of business activity.

Rev. Proc. 74-33, 1974-2 C.B. 489, provides, in part, that where a trade or business has a non-peak period and a peak period of business, the natural business year is deemed to end at, or soon after, the close of the peak period of business. A business whose income is steady from month to month, year around, would not have a natural year as such.

Rev. Proc. 72-51, 1972-2 C.B. 832, provides, in part, that a request by an electing small business corporation to change to an accounting period differing from that of its shareholders will generally be approved if the request for change will result in a deferment of income to the shareholders of 3 months or less.

In the instant case, the taxpayer has requested permission to change from a calendar year to a fiscal year ending March 31 for the sole, one-time reason of aiding the selling and purchasing shareholders in allocating the income of the taxpayer on a "cut off" basis to the shareholders' individual tax returns. The sale of the taxpayer's stock in no way affected the taxpayer's annual cycle of business activity and had no bearing on the continued operation of the taxpayer's business.

Furthermore, the net effect of this one-time occurrence (change in stock ownership) followed by a change in annual accounting period to March 31 would be to produce a permanent deferment in the reporting of the taxpayer's income by the new shareholders that would be contrary to the intent of both section 1.442-1(b) of the regulations and Rev. Proc. 72-51.

Accordingly, in the instant case, the taxpayer has not shown a substantial business purpose for the granting of a change of its annual accounting period from a calendar year to a fiscal year ending March 31.

Part II.—Methods of Accounting
Subpart A.—Methods of Accounting in General

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446-1: General rule for methods of accounting.

Conditions that must be met by casualty insurance companies wishing to change their method of accounting for salvage. See Rev. Proc. 76-42, page 666.

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26 CFR 1.446-1: General rule for methods of accounting.

Whether investment tax credit is allowable to a taxpayer for costs of labor and material incident to the installation of depreciable assets prior to 1974, when the taxpayer voluntarily requested, in accordance with sections 446 and 481 of the Code, a change in method of accounting from deducting installation costs to capitalizing installation costs beginning with taxable year 1974. See Rev. Rul. 76-437, page 12.

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26 CFR 1.446-1: General rule for methods of accounting.

Permissible changes of methods of accounting for Class Life Asset Depreciation Range property. See Rev. Rul. 76-438, page 49.

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26 CFR 1.446-1: General rule for methods of accounting.

A consistent method of reducing losses paid by an estimate of future salvage recoveries in computing "losses incurred" is a method of accounting, and as such, any change from such method requires the consent of the Commissioner. See Rev. Rul. 76-487, page 210.

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26 CFR 1.446-1: General rule for methods of accounting.

Whether a deduction for depletion is to be taken into account in the year oil is sold rather than in the year in which it is produced and moved from the premises. See Rev. Rul. 76-533, page 189.

Subpart B.—Taxable Year for Which Items of Gross Income Included

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Section 451.—General Rule for Taxable Year of Inclusion

26 CFR 1.451-2: Constructive receipt of income.

Whether interest earned on a time savings certificate is to be reported as original issue discount on Form 1099-OID. See Rev. Rul. 76-449 page 393.

Section 453.—Installment Method

26 CFR 1.453-1: Installment method of reporting income.

Installment sales; condominium units. An individual taxpayer selling condominium units, who assumed all risks relating to possible default of a purchaser and reimbursed a mortgage company for expenses relating to the loans under a contract that provided that the company make loans in its name to purchasers of the units, insure the purchaser's payments on the notes, transfer the notes to the taxpayer at face value following each loan, and collect the installment payments, is not considered as having received any payments from the purchasers and may elect to report income from the sale of the units on the installment method.

Rev. Rul. 76-269

Advice has been requested whether, under the circumstances described below, a taxpayer may elect to report income from the sales of real property on the installment method under sec-

tion 453(b) of the Internal Revenue Code of 1954.

An individual taxpayer desired to sell condominium units on a deferred payment basis and to insure the purchasers' payments with a mortgage insurance company. However, the mortgage insurance company would insure only the loans of, or originated by, an approved lender, such as a mortgage company or other companies in the business of making loans. Therefore, the taxpayer contracted with a mortgage company to make loans in the mortgage company's name to the purchasers for their purchase of the units, to insure each purchaser's payments on the notes, and to transfer each purchaser's note to the taxpayer at its face value immediately following the making of each loan. The taxpayer was subject to all risks relating to the possible default of a purchaser and had no recourse against the mortgage company with respect to the transfer of any such note. The mortgage company also agreed to close the condominium unit sales with the purchasers and collect the purchasers' installment payments for the taxpayer. For processing each loan, the taxpayer agreed to pay the mortgage company a fee of one percent of the original principal amount of the loan in addition to reimbursing the mortgage company for its expenses in connection with the loan, including the mortgage insurance fees. Additional compensation was agreed to for collecting the installment payments on the loans. The principal amount of each loan was payable in 300 equal monthly installments. No purchaser made monthly installment payments in excess of those required, and no purchaser made a down payment.

Section 453(b) of the Code permits, at the taxpayer's election, income from the sale of real property to be reported under the installment method of accounting if, in the taxable year of the sale, the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price.

In the instant case, the mortgage company acted as the taxpayer's agent in these transactions because, though the mortgage company loaned the purchasers the purchase price of the condominiums and insured the purchasers' payments in its own name, the company acted primarily under the taxpayer's control and to protect the interests of the taxpayer. The mortgage company bore no appreciable risk of loss, because the taxpayer acquired the purchasers' notes at their face value from the mortgage company and reimbursed it for the mortgage insurance fees and other expenses it incurred in connection with the loans. Thus, the taxpayer, through the taxpayer's agent, financed the amounts received from the purchasers so that the substance of the transactions was the same as if the taxpayer had received the notes directly from the purchasers. Therefore, the taxpayer is not considered to have received any payments from the purchasers at the time of the sales of the condominium units.

Accordingly, in the instant case, the taxpayer may elect to report the income received from the sales of the condominium units on the installment method under section 453 of the Code.

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26 CFR 1.453-1: Installment method of reporting income.

Installment sales; payment in year of sale; debt cancellation. A taxpayer whose stock was redeemed by the corporation for cash, the cancellation of an unrelated debt, and promissory notes payable over a period of years must include the cancelled debt as an amount received in the year of sale for purposes of the 30 percent test under section 453(b)(2)(A)(ii) of the Code in determining whether gain may be reported under the installment method; Rev. Rul. 71-543 distinguished.

Rev. Rul. 76-398

Advice has been requested whether, under the circumstances described below, the installment method of reporting income provided by section 453 of the Internal Revenue Code of 1954 may be used to report the gain realized by a taxpayer upon the redemption of stock.

A, an individual who files his Federal income tax returns on a calendar year basis, held stock in corporation *X* and corporation *Y*. On December 1, 1975, *X* and *Y* redeemed their stocks held by *A* in transactions that qualified as distributions in full exchange for the stocks under section 302(a) of the Code. As part of the purchase price, *X* and *Y* canceled personal loans that had previously been made to *A* in the amounts of $30,000 and $15,000 respectively. These loans were unrelated to the stocks redeemed by *X* and *Y*.

As indicated below the stock purchase contract in each case provided for a cash payment to *A*, cancellation of *A*'s indebtedness, and the payment of the balance of the purchase price to A:

	X	*Y*
Contract price	$165,000	$140,000
Down payment:		
Cash	30,000	20,000
Cancellation of Debt	30,000	15,000
	60,000	35,000
Balance due *A*	$105,000	$105,000

The balances due A were evidenced by the promissory notes of *X* and *Y*, each bearing interest at the rate of 7 percent. The notes were payable in fifteen equal annual installments beginning in 1976.

Under section 453 of the Code, a taxpayer may elect to report the gain from the sale of personal property

using the installment method of accounting.

Section 453(b)(2)(A)(ii) of the Code provides, in part, that the installment method of reporting income is available only if the payments received in the year of sale do not exceed 30 percent of the sales price.

In *Riss v. Commissioner,* 368 F.2d 965 (10th Cir. 1966), the United States Court of Appeals held that cancellation by a corporation of a partnership's indebtedness to it as part of the consideration for the sale of stock was equivalent to payment received in the year of sale. See also Rev. Rul. 71-515, 1971-2 C.B. 222, which holds that the cancellation of a note at the time a deed to realty was conveyed was includible by the seller as an amount received in the year of sale.

Accordingly, in the instant case, *A* must include as payments received in 1975 the amount of debts canceled by *X* and *Y*. Consequently, *A* is precluded from using the installment method in reporting the gain resulting from the redemption by *X* because the amount of the canceled debt ($30,000) when added to the cash payment received by *A* in 1975 ($30,000) exceeded 30 percent of the contract price ($49,500). However, *A* may use the installment method to report the gain resulting from the redemption by *Y* because the amount of the canceled debt ($15,000) when added to the cash payment received by *A* in 1975 ($20,000) did not exceed 30 percent of the contract price ($42,000).

Rev. Rul. 71-543, 1971-2 C.B. 223, which holds that the amount of debt owed on stock that is assumed by the purchaser is not includible in payments received by the seller in the year of sale for purposes of the 30 percent test under section 453 of the Code is distinguished. In Rev. Rul. 71-543, the assumption of the debt owed on the stock is considered to be the same as the assumption of an existing mortgage in connection with a sale of property. In such an instance, only that portion of the assumed debt that exceeds the seller's basis is considered for purposes of the 30 percent test. In Rev. Rul. 71-543, the assumed debt did not exceed the seller's basis and, therefore, was not included in determining the payments received during the taxable year of sale.

Rev. Rul. 71-543 is distinguished.

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26 CFR 1.453-1: Installment method of reporting income.
(Also Section 752; 1.752-1.)

Installment sale; partnership interest; liabilities assumed by purchaser. The share of the partnership liabilities assumed by the purchaser of a partnership interest that does not exceed the basis of the interest sold is not treated as a payment in the year of sale for purposes of the 30 percent requirement of section 453(b) of the Code, even though the entire amount of the liabilities assumed is treated as part of the amount realized by the selling partner for purposes of computing gain or loss.

Rev. Rul. 76-483

Advice has been requested whether, under the circumstances described below, partnership liabilities assumed by the purchaser in a sale of a partnership interest on the installment method will be treated as payments in the year of sale for purposes of the limitations contained in section 453(b) of the Internal Revenue Code of 1954.

A taxpayer sold an interest in a general partnership at a gain and elected to report the gain on the installment method provided by section 453 of the Code. The agreed selling price for the partnership interest, net of the taxpayer's share of partnership liabilities, was $20,000, for which the seller received a cash downpayment of $8,000 in the year of sale and a nonnegotiable note of the purchaser in the face amount of $12,000 to be paid at the rate of $2,000 each year for the succeeding six years. The note bears a stated rate of interest of 8 percent. The taxpayer's share of partnership liabilities assumed by the purchaser was $80,000. At the time of the sale, the partnership had no assets of a character described in section 751 (unrealized receivables and substantially appreciated inventory items) and the taxpayer's basis in the partnership interest was $90,000.

Section 453(a) of the Code provides, in part, that a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

Section 453(b)(1) of the Code provides, in part, that income from the casual sale of personal property (other than property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000 may be returned on the installment method.

Section 453(b)(2) of the Code provides, in part, that section 453(b)(1) shall apply in the case of a sale or other disposition during a taxable year beginning after December 31, 1953, only if in the taxable year of sale or other disposition there are no payments, or the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price.

Section 1.453-4(c) of the Income Tax Regulations provides, in part, that in the sale of mortgaged property, the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as part of the selling price, and for the purpose of determining the payments and total contract price

under section 453 of the Code, the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property.

For purposes of section 453 of the Code, the "selling price" includes the amount of any money received, the fair market value of any property received, the amount of any notes or other evidences of indebtedness of the buyer, and any liabilities of the seller that are assumed by the buyer or that pass to the buyer as liens against the property transferred.

For purposes of section 453 of the Code, the "contract price" is the total amount of cash or property actually paid or to be paid to the seller under the contract (other than amounts paid as interest) for the seller's equity in the property.

Section 741 of the Code provides that in the case of a sale or exchange of an interest in a partnership, gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items that have appreciated substantially in value).

Section 752(d) of the Code provides that in the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale of property not associated with partnerships. Therefore, as illustrated in section 1.752-1(d) of the regulations and consistent with section 453 and the regulations thereunder, the purchaser's assumption of partnership liabilities in connection with the sale or exchange of a partnership interest is treated as part of the amount realized by the selling partner on the sale of the partnership interest.

In the instant case, the sale of the partnership interest satisfies the percentage requirement of section 453(b) of the Code because the cash downpayment of $8,000 in the year of sale is less than 30 percent of $100,000, the total amount realized for the sale of the partnership interest, which is made up of the total of the downpayment in the year of sale of $8,000, the purchaser's note of $12,000, and the partnership liabilities assumed by the purchaser of $80,000. The fact that the downpayment of $8,000 is more than 30 percent of the contract price of $20,000 is of no consequence, since the 30 percent is based on the selling price pursuant to section 1.453-4(c) of the regulations.

Accordingly, in the instant case, since the partnership liabilities of $80,000 assumed by the purchaser did not exceed the basis of the partnership interest of $90,000, their assumption by the purchaser will not be treated as a payment in the year of sale for purposes of section 453 of the Code.

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26 CFR 1.453-9: Gain or loss on disposition of installment obligations.

Installment obligation; fractional interest transferred to trust. The transfer of a fractional interest in an installment obligation to an irrevocable trust is a disposition of such interest and the taxpayer must recognize as gain or loss in the year of transfer the difference between the basis allocable to the interest transferred and its fair market value; the trust must include in income any interest that may accrue on the part of the installment obligation it received.

Rev. Rul. 76-530

Advice has been requested whether the proposed transfer of a fractional interest in installment obligations will be a "disposition" within the meaning of section 453(d) of the Internal Revenue Code of 1954.

In 1975, an individual taxpayer sold stock of a corporation for an amount in excess of $1,000 and received less than 30 percent of the selling price in cash. The balance of the selling price is to be received in monthly installments beginning in 1976 as evidenced by a note and deed of trust (installment obligations). Interest is to be paid on the outstanding balance of the selling price at the rate of 9 percent a year. The taxpayer realized a gain from the sale of the stock and elected to report such gain on the installment method under section 453(b) of the Code.

The taxpayer established and funded an irrevocable trust for the benefit of the taxpayer's grandchildren. A bank was designated trustee. The taxpayer did not retain any interests or powers with respect to the trust that would cause the taxpayer to be treated as the owner of any portion of the trust under subpart E, part I, subchapter J, chapter 1 of the Code (sections 671 to 678 inclusive). The taxpayer now proposes to make an irrevocable gift to the trust of a fractional interest in the installment obligations. The gift would be valid under applicable state law. Also, the taxpayer will continue to report income on the installment method with respect to the portion of the installment obligations that will not be transferred to the trust.

Section 453(b) of the Code provides, in part, that income from a casual sale of personal property (excluding inventory items) for a price exceeding $1,000 may be reported on the installment method of accounting in the manner prescribed in section 453(a), if, in the year of sale, there are no payments, or the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price. Section 453(a)(1) provides for the reporting of income on the installment method of accounting when the installment payments are actually received.

Section 453(d) of the Code provides, in part, that if an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the

obligation and (A) the amount realized, in the case of satisfaction at other than face value or a sale or exchange or (B) the fair market value of the obligation at the time of the distribution, transmission, or disposition otherwise than by sale or exchange. Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

In *A. W. Legg,* 57 T.C. 164 (1971), *aff'd,* 496 F.2d 1179 (9th Cir. 1974), taxpayers sold an apple orchard and elected to report the gain on the installment method. Contemporaneous with the sale, the taxpayers conveyed the installment sales contract to an irrevocable trust, retaining the right to receive an annual payment of $6,000, with the corpus payable on the taxpayers' death to a charitable foundation. The United States Tax Court held that the transfer of the installment obligation to the trust was a disposition of such installment obligation within the meaning of section 453(d) of the Code.

The Tax Court of the United States also held in *Harry F. Shannon,* 29 T.C. 702, 725 (1958), that a distribution by a trustee to beneficiaries of interests in an installment note was a distribution within the meaning of section 44(d) of the Internal Revenue Code of 1939 (the predecessor of section 453(d) of the 1954 Code).

In the instant case the transfer by the taxpayer of the fractional interest in the installment obligations to the trust will be similar to the transfer of the principal interest in the installment obligation described in *A. W. Legg.*

Accordingly, the transfer of a fractional interest in the installment obligations will be a disposition under section 453(d) of the Code to the extent of the fraction transferred. The taxpayer must recognize gain or loss in the year of the transfer to the extent of the difference between the basis allocable to the fractional interest transferred and the fair market value of such fractional interest. Further, any interest that may accrue on the fractional interest of the installment obligations transferred to the trust will be includible in the income of the trust.

Subpart C.—Taxable Year for Which Deductions Taken

Section 461.—General Rule For Taxable Year of Deduction

26 CFR 1.461-1: General rule for taxable year of deduction.
(Also Section 163; 1.163-1.)

Banks; accrual of interest; certificate of deposit redeemed before maturity. A commercial bank is permitted the full accrual of interest expense on a time certificate of deposit issued on or after July 6, 1973, the date Federal regulations were amended to remove the hardship requirement permitting early redemption, notwithstanding the possibility that the depositor and bank may subsequently agree to an early redemption; Rev. Rul. 71-63 amplified.

Rev. Rul. 76-308

Advice has been requested whether Rev. Rul. 71-63, 1971-1 C.B. 143, permits the full accrual of interest expense by a commercial bank on a time certificate of deposit (CD) under the circumstances described below.

In Rev. Rul. 71-63 a bank issued a 12-month CD on August 1, 1968, at a stated rate of interest. Under the terms of the CD, the bank could, at its discretion, permit redemption before maturity if the depositor, in an emergency, could show hardship justifying an early redemption. An early redemption would cause the depositor to forfeit 3 months' interest. Rev. Rul. 71-63 holds that the possibility that the parties to the contract may subsequently agree to modify its terms (a novation) is not a contingency that prevents the accrual of interest by the bank in accordance with the presently existing terms.

The CD referred to in Rev. Rul. 71-63 was governed by the regulations issued by the Federal Reserve System under Regulation Q, 12 C.F.R. Part 217 (1936).

Regulation Q, prior to its amendment on July 5, 1973, provided that a time deposit could be paid before maturity only in an emergency when it was necessary to prevent great hardship to the depositor. Under the amended provisions of Regulation Q, effective July 6, 1973, a member bank is permitted to pay a time deposit before maturity, but in such event the bank can pay interest on the amount withdrawn at a rate not to exceed the maximum rate prescribed for a savings deposit during the period the funds have remained on deposit, less 3 months interest. *See* 12 C.F.R. section 217.4(d) (1974).

The amendment of the rules under Regulation Q removes the "great hardship" requirement necessary to permit an early redemption of the CD. However, the relationship of the parties to the contract (the CD) has not changed. The depositor still enters into a contract to leave funds on deposit until the stated maturity. 12 C.F.R. section 217.4(e) requires the bank to alert the depositor to the terms of the CD and advise the depositor that the funds are required to be kept on deposit until the stated maturity. Notwithstanding the contract provisions, however, the bank may permit payment before maturity.

Section 163 of the Code states that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 461 of the Code provides the general rules for the taxable year of deduction. Section 1.461-1(a)(2) of the regulations provides that, under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred

that determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

Although Regulation Q was amended on July 5, 1973, to remove the requirement that the depositor demonstrate "great hardship" in order to obtain an early withdrawal of a CD, the requirement that both the depositor and the bank must agree before an early redemption of the CD will be effective remains unchanged.

It is the subsequent agreement between the parties to modify the terms of the original contract that is a novation; not the fact that one party must establish the occurrence of an event (great hardship) precedent to the substituted agreement. The possibility of renegotiation by the parties to the original agreement, which possibility is inherent in every contract, is not a contingency that will prevent the accrual of interest under section 461 of the Code and section 1.461-1(a)(2) of the regulations. *See*, for example, *Louis S. Cohn Co.*, 12 B.T.A. 1281 (1928), which held that an amount accrued and paid in 1920 as an insurance premium by an accrual basis taxpayer, although refunded in the following year on the cancellation (by mutual agreement) of the contract, is a proper deduction as an expense in 1920.

Accordingly, Rev. Rul. 71-63 permits the full accrual of interest expense on a CD issued on or after July 6, 1973, the date Regulation Q was amended to remove the hardship requirement for an early redemption of a CD. Furthermore, this rule applies whether a CD is issued during the last 3 months of the commercial bank's taxable year or prior to the last 3 months of the bank's taxable year.

For deposits made after December 31, 1970, with respect to certificates of deposits and other deposit arrangements issued with original issue discount, section 1.163-4 of the regulations provides that the amount of such discount is deductible as interest and shall be prorated over the life of the obligation. This Revenue Ruling is not applicable to those situations governed by section 1.163-4.

Rev. Rul. 71-63 is amplified.

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26 CFR 1.461-1: General rule for taxable year of deduction.

Deduction; contributions to profit-sharing plan for dealers. The Service will not follow the **Washington Post Company** decision holding that an accrual method taxpayer may deduct the full amount accrued under a profit sharing plan established for its independent circulation dealers, for which its liability is fixed and certain with respect to the group as a whole, but for which the ultimate recipients, the time of actual payout, and the amount payable to each recipient cannot be ascertained in the year of accrual.

Rev. Rul. 76-345

The Internal Revenue Service has been requested to state whether it will follow in other cases the decision of the United States Court of Claims in the case of *Washington Post Company v. United States*, 405 F. 2d 1279 (1969).

The issue in the *Washington Post* case was whether an accrual method taxpayer may deduct the full amount it accrued under a profit-sharing plan (plan) that had been established for the benefit of its circulation dealers (who were stipulated to be independent contractors and not employees of the newspaper publisher) where part of such amounts is not irrevocably vested in the individual dealers. Under the facts in this case, the taxpayer, in order to provide incentives to its circulation dealers, both to increase sales volume and to maintain a beneficial continuing relationship with the dealers, established a profit-sharing plan. Each year the board of directors allocated to the plan a certain sum that was accrued as a liability on the taxpayer's books and credited to the individual account of each of the dealers With certain exceptions, if an individual ceased to be a dealer prior to reaching the age of 55 he would receive ten percent of the amount credited to his account in the plan for each year of service up to a maximum of 70 per cent. The balance of his account in the plan would be forfeited and reallocated to the remaining dealers in the plan. In the event that the plan was discontinued the amounts accumulated under the plan would irrevocably vest with the dealers who were members of the plan at the time of termination.

The court held that where the taxpayer irrevocably committed itself to payment of whatever amount accrued to the plan and the amount was definitely fixed as of time of accrual, the taxpayer could deduct the full amount accrued even though the ultimate recipients and time of actual payout were undetermined in part.

In arriving at its decision the court stated that when a "group liability" is involved, it is the certainty of the liability that is the utmost importance in the "all events" test, and not necessarily either the certainty of the time over which payment will be made or the identity of the payees.

The "all events" test set forth in section 1.461-1(a)(2) of the Income Tax Regulations provides that an expense is deductible by an accrual method taxpayer for the taxable year in which all the events have occurred which determine the fact of the liability, and the amount thereof can be determined with reasonable accuracy. See also *United States v. Anderson*, 269 U.S. 42 (1926), V-I C.B. 179 (1926). If there is any doubt that the liability will occur, it may not be deducted until the liability becomes absolute. See *Brown v. Helvering*, 291 U.S. 193, 20 (1934), XIII-1 C.B. 223 (1934).

Where a taxpayer's liability under a plan is fixed and certain only with respect to a group as a whole, the "all events test" set forth in section 1.461-(a)(2) of the regulations is not sati

fied. Since the group is subject to constant change, neither the ultimate recipients nor the time of distribution can be ascertained in the year of accrual. The "all events test" can be met only when the fact of the liability to a specified individual participant has been clearly established and the amount of liability to each individual can be determined with reasonable accuracy. See also *Keco Industries, Inc.*, 26 P-H Tax Ct. Mem. 51 (1957), appeal dismissed on stipulation (CA-6), which holds that in deferred compensation plans for employees the nonforfeitability requirement of the Code refers to the rights of specific beneficiaries and not the rights of employees as a class.

In view of the foregoing, the Service will not follow the decision in the *Washington Post Company* case as a precedent in the disposition of similar cases.

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26 CFR 1.461-1: General rule for taxable year of deduction.
(Also Section 162; 1.162-11.)

Real property taxes as additional rent. An accrual-method lessee who is obligated on January 1 to pay as additional rent the real estate taxes on the leased property which accrue on that date, but become payable on June 1 of the following year when the tax bills are issued to the lessor, may accrue and deduct the taxes as additional rent on January 1; Rev. Rul. 74-244 clarified and distinguished.

Rev. Rul. 76-474

Advice has been requested concerning the proper time for accrual of a lessee's additional rent liability for the lessor's real estate taxes under the circumstances described below.

The taxpayer, a domestic corporation, leased real property for use in its business. In addition to paying the stated rent, the taxpayer, as lessee, is required under the terms of the lease to pay the owner-lessor's real estate taxes on the leased property. The real estate tax year is the calendar year 1976. The lease is for the 12-month period January 1, 1976 through December 31, 1976.

The taxpayer-lessee uses the accrual method of accounting and files its Federal income tax returns on a calendar year basis.

The law of the state in which the property is located provides that the owner of real property on January 1 in any year shall be liable for the real estate tax for that year, that on January 1 such tax becomes a lien on the property, and that the tax is payable by the owner on June 1 of the following year when the tax bills are issued. Under the terms of the lease, the taxpayer-lessee on January 1, 1976, became obligated for a base rental of 2,000x dollars for the 12-month period. In addition to paying this stated rent the lessee is required to pay as additional rent all real estate taxes that may accrue with respect to the property during the 12-month lease term. However, the lessee is not required to pay such additional rent until June 1, 1977, the date when the owner-lessor is required to pay the real estate taxes. The lease provides that this liability exists, regardless of whether the taxpayer is leasing the property on June 1, 1977.

Section 1.162-11(a) of the Income Tax Regulations provides, in part, that the taxes paid by a tenant for a landlord for business property are additional rent and constitute a deductible item to the lessee.

Section 1.461-1(a)(2) of the regulations provides, in part, that under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred that determine the fact of liability and the amount thereof can be determined with reasonable accuracy.

In the instant case, under the terms of the lease the lessee became liable for the regular rent and the additional rent on January 1, 1976. If the lease is terminated at any time after it goes into effect, the lessee is liable to the lessor for such additional rent under the same conditions as would apply to the regular rent for the balance of the term of the lease.

Accordingly, the taxpayer-lessee may accrue and deduct the real estate taxes for 1976 as additional rent in the calendar year 1976, because under the terms of the lease agreement, the lessee's liability to pay the additional rent for the use of the property during the lease term became fixed on January 1, 1976, within the meaning of the provisions of section 1.461-1(a)(2) of the regulations.

The instant case is distinguishable from Rev. Rul. 74-244, 1974-1 C.B. 118. Rev. Rul. 74-244 concludes, under a similar state law, that the lessee may not accrue the real estate taxes as additional rent until June 1 of the year in which the real estate taxes are payable. The distinction is based on a difference in the lease in each case. In Rev. Rul. 74-244, under the terms of the lease, the lessee's liability for the additional rent did not become fixed within the meaning of the provisions of section 1.461-1(a)(2) of the regulations until June 1 of the year in which the lessor was obligated to pay the tax. Although Rev. Rul. 74-244 does not state that if the lease described therein is terminated prior to June 1 of a year, the lessee will not be liable for payments of the prior year's real estate taxes as rent, that fact is implied in Rev. Rul. 74-244, and is considered to be a fact necessary to support the rationale and holding in that Revenue Ruling.

Rev. Rul. 74-244 is clarified and distinguished.

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26 CFR 1.461-1: General rule for taxable year of deduction.

Whether a taxpayer can deduct state property taxes in full on the lien date and the franchise tax in full on the accrual date in computing annualized taxable income for the purpose of determining whether the exception to the addition to the tax for underpayment of estimated tax provided by

section 6655(d)(3) of the Code is applicable. See Rev. Rul. 76-450 page 444.

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26 CFR 1.461-1: General rule for taxable year of deduction.

Whether a taxpayer using the accrual method of accounting and who computes its income on the basis of a 52-53-week taxable year, may deduct, in a taxable year, two assessments for real property taxes under sections 441 and 461 of the Code. See Rev. Rul. 76-482 page 127.

Subpart D.—Inventories

Section 471.—General Rule for Inventories

26 CFR 1.471-2: Valuation of inventories.

Application of section 1.471-2 of the regulations, concerning inventory write-downs, to the use of the last-in, first-out (LIFO) inventory method. See Rev. Proc. 76-28, page 645.

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26 CFR 1.471-2: Valuation of inventories.

Whether the adjustment required under section 472(d) of the Code with respect to any write-down from actual cost must be applied to goods in inventory that are unsalable at normal prices or unusable in the normal way as well as normal goods that have been written down to market value for Federal income tax purposes. See Rev. Rul. 76-282 page 137.

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26 CFR 1.471-11: Inventories of manufacturers.

Whether a taxpayer that uses the last-in, first-out inventory method may change to the full absorption method for tax purposes, while continuing to use a more inclusive method for costing its inventory for other than tax purposes without violating the conformity requirements of section 472(c) and (e) of the Code. See Rev. Rul. 76-379, page 138.

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26 CFR 1.471-11: Inventories of manufacturers.

Whether the difference in the treatment of production costs variances for Federal income tax and financial reporting purposes is a violation of the LIFO conformity requirements set forth in section 472(c) and (e) of the Code. See Rev. Rul. 76-531, page 140.

Section 472.—Last-In, First-Out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

Rev. Rul. 76-465

The following price indexes for January 1976, published by the Bureau of Labor Statistics on March 5, 1976, for use by department stores employing the retail inventory and last-in, first-out inventory methods, are accepted by the Internal Revenue Service pursuant to section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 72-21, 1972-1 C.B. 745, for appropriate application to inventories for taxable years of 12 months ended December 31, 1975, and January 31, 1976.

Indexes are given on a national basis for the store total, for 20 major groups of departments, and for two special combinations—soft and durable goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, paints, and wallpaper, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES, BY DEPARTMENT GROUPS
[January 1941 = 100]

	Department Group	Jan. 1975	Jan. 1976	Percentage Change from Jan. 1975 to Jan. 1976 [1]
I	Piece Goods	274.7	279.3	1.7
II	Domestics and Draperies	320.4	328.2	2.4
III	Women's and Children's Shoes	406.8	401.2	—1.4
IV	Men's and Boys' Shoes	442.7	439.2	— .8
V	Infants' Wear	291.5	300.0	2.9
VI	Women's Underwear	247.6	257.9	4.2
VII	Women's and Girls' Hosiery	166.3	167.4	.7
VIII	Women's and Girls' Accessories	318.1	327.8	3.0
IX	Women's Outerwear and Girls' Wear	295.1	302.5	2.5
X	Men's Clothing	367.9	370.4	.7
XI	Men's Furnishings	303.2	304.7	.5
XII	Boy's Clothing and Furnishings	302.9	307.2	1.4
XIII	Jewelry	397.1	416.6	4.9
XIV	Notions	302.1	315.6	4.5
XV	Toilet Articles and Drugs	314.1	339.4	8.1
XVI	Furniture and Bedding	354.7	368.4	3.9
XVII	Floor Covering	257.2	277.3	7.8
XVIII	Housewares	411.8	445.7	8.2
XIX	Major Appliances	166.6	176.0	5.6
XX	Radio and Television Sets	110.8	112.6	1.6
	Groups I - XV: Soft Goods	318.2	326.8	2.7
	Groups XVI - XX: Durable Goods	290.8	307.5	5.7
	Store Total	310.2	321.1	3.5

[1] Absence of a minus sign before percentage change in this column signifies price increase.

26 CFR 1.472-1: Last-in, first-out inventories.

Rev. Rul. 76-466

The following price indexes for July 1976, published by the Bureau of Labor Statistics on September 7, 1976, for use by department stores employing the retail inventory and last-in, first-out inventory methods, are accepted by the Internal Revenue Service pursuant to section 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 72-21, 1972-1 C.B. 745, for appropriate application to inventories for taxable years of 12 months ended June 30, 1976, and July 31, 1976.

Indexes are given on a national basis for the store total, for 20 major groups of departments, and for two special combinations—soft and durable goods. The store total index covers all departments, including some not listed separately, with the following exceptions: candy, foods, liquor, tobacco, paints, and wallpaper, as well as contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES, BY DEPARTMENT GROUPS
[January 1941 = 100]

	Department Group	July 1975	July 1976	Percentage Change from July 1975 to July 1976 [1]
I	Piece Goods	282.3	280.8	— .5
II	Domestics and Draperies	325.3	343.3	5.5
III	Women's and Children's Shoes	407.4	421.4	3.4
IV	Men's and Boys' Shoes	442.5	468.7	5.9
V	Infants' Wear	296.0	309.6	4.6
VI	Women's Underwear	253.0	269.6	6.6
VII	Women's and Girls' Hosiery	171.7	174.5	1.6
VIII	Women's and Girls' Accessories	328.3	333.9	1.7
IX	Women's Outerwear and Girls' Wear	295.5	299.3	1.3
X	Men's Clothing	370.4	372.5	.6
XI	Men's Furnishings	306.3	313.9	2.5
XII	Boys' Clothing and Furnishings	307.1	312.2	1.7
XIII	Jewelry	405.5	427.0	5.3
XIV	Notions	313.0	328.1	4.8
XV	Toilet Articles and Drugs	334.1	351.6	5.2
XVI	Furniture and Bedding	365.4	378.3	3.5
XVII	Floor Covering	267.4	287.3	7.4
XVIII	Housewares	433.8	458.2	5.6
XIX	Major Appliances	173.1	179.1	3.5
XX	Radio and Television Sets	111.3	112.1	.7
	Groups I - XV: Soft Goods	323.6	333.7	3.1
	Groups XVI - XX: Durable Goods	301.6	314.6	4.3
	Store Total	317.3	328.2	3.4

[1] Absence of a minus sign before percentage change in this column signifies price increase.

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26 CFR 1.472-1: Last-in, first-out inventories.

The procedure to be used by the Service in the examination of Federal income tax returns involving the last-in, first-out (LIFO) inventory requirements of section 472(c) and (e)(2) of the Code for the taxable year in which the taxpayer elects to use the LIFO inventory method, re-elects such method or extends an existing LIFO election to cover all or a greater portion of its inventories, as well for subsequent taxable years, and the Bureau of Census, an agency within and under the jurisdiction of the U.S. Department of Commerce, request that the taxpayer furnish certain information to it. See Rev. Proc. 76-36, page 659.

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26 CFR 1.472-2: Requirements incident to adoption and use of LIFO inventory method.
(Also Sections 471, 7805; 1.471-2, 301.7805-1.)

LIFO; change; preceding year's closing inventory. A taxpayer electing the LIFO inventory method for a particular class of goods must include all goods within that class, including subnormal goods, and the adjustment required under section 472(d) of the Code must include any write-down from actual cost. This ruling will not apply to certain goods disposed of prior to September 24, 1976.

Rev. Rul. 76-282[1]

Advice has been requested whether the adjustment required under section 472(d) of the Internal Revenue Code of 1954 is applicable to the taxpayer's goods under the circumstances described below.

The taxpayer seeks to adopt and use the last-in, first-out (LIFO) inventory method in taxable year 1975. Currently, all of the taxpayer's goods are includible in inventory under section 1.471-1 of the Income Tax Regulations. The taxpayer proposes to apply the adjustment required under section 472(d) of the Code to normal goods, but not to those goods described in section 1.471-2(c) that are unsalable at normal prices or unusable in the normal ways because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes. For purposes of this Revenue Ruling, the type of goods written down under section 1.471-2(c) shall be referred to collectively as "subnormal goods."

The specific issue is whether the ad-

[1] Also released as News Release IR-1630, dated July 2, 1976.

justment required by section 472(d) of the Code applies to goods in inventory that are unsalable at normal prices or unusable in the normal way whose carrying value has been reduced pursuant to section 1.471-2(c) of the regulations.

Section 1.471-2(c) of the regulations deals with the valuation of inventories. It states that the bases of valuation most commonly used to meet the requirements of section 471 of the Code are (1) cost and (2) cost or market, whichever is lower. However, any goods in an inventory that are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether cost or cost or market, whichever is lower, is used.

Section 472, of the Code allows a taxpayer to elect, subject to approval by the Commissioner of Internal Revenue, to use the LIFO method of identifying items in the closing inventory.

Section 472(d) of the Code provides, in part, with respect to an application to change to the LIFO inventory method, that in determining income for the taxable year preceding the taxable year for which the LIFO method is first used, the closing inventory of such preceding year of the goods specified in the application shall be at cost.

Section 1.472-2 of the regulations states the requirements incident to the adoption and use of the LIFO inventory method.

Section 1.472-2(b) of the regulations provides that under the LIFO inventory method the inventory shall be taken at cost regardless of its market value.

Section 1.472-2(c) of the regulations provides that goods of the specified type included in the opening inventory of the taxable year for which the method is first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the prior taxable year with the exception that restoration shall be made with respect to any write-down to market value resulting from the pricing of former inventories.

Rev. Proc. 76-6, 1976-1 C.B. 545, sets forth procedures relating to the proper adoption and use of the LIFO-inventory method and the required restoration of any write-down to market value resulting from the pricing of former inventories under section 472(d) of the Code.

Accordingly, for purposes of section 1.472-2 of the regulations, the taxpayer's right to select the class or classes of goods to be covered by the LIFO election (or extension) goes to the nature of the goods and not to their condition, salability or other characteristics. Therefore, when the LIFO method is elected (or extended) for a particular class of goods, the election must include all goods within that class regardless of whether they are normal goods or goods that are unsalable at normal prices or unusable in the normal way. It is further held that the adjustment required under section 472(d) of the Code must include any write-down from actual cost with respect to goods that are unsalable at normal prices or unusable in the normal way, as well as normal goods that have been written down to market value under section 1.471-4.

With respect to a taxpayer that has a LIFO election in effect for a taxable year(s) prior to the effective date of this ruling, (taxable years beginning on and after 60 days from July 26, 1976, the date of publication of this ruling in Internal Revenue Bulletin 1976-30), under the authority contained in section 7805(b) of the Code this Revenue Ruling will not apply to goods disposed of prior to the effective date of this Revenue Ruling whose carrying value has been determined by reference to section 1.471-2(c) of the regulations. If a taxpayer has on hand at the beginning of the first taxable year commencing on and after the effective date of this Revenue Ruling, goods whose carrying value has been determined by reference to section 1.471-2(c), such goods must be valued at cost as of the end of the preceding taxable year to the extent such restoration has not been previously made. Any restoration of a write-down to market value for purposes of section 472(d) must be made in accordance with the provisions of Rev. Proc. 76-6, as revised, with respect to any goods whose carrying value has been determined under section 1.471-4. See Rev. Proc. 76-28, page 645, this Bulletin, for further implementation of this ruling.

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26 CFR 1.472-2: Requirements incident to adoption and use of LIFO inventory method.
(Also Section 471; 1.471-11.)

LIFO; full absorption method financial conformity. A taxpayer that changes from a more inclusive LIFO inventory method to a less inclusive LIFO inventory method under section 1.471-11 of the regulations for Federal income tax purposes may continue to value its LIFO inventories under the previous more inclusive method for financial statement purposes without violating the conformity requirements of section 472(c) and (e) of the Code.

Rev. Rul. 76-379

Advice has been requested whether a taxpayer that uses the last-in, first-out (LIFO) inventory method may change to the full absorption method of costing its LIFO inventory under

section 1.471-11 of the Income Tax Regulations for tax purposes and continue to report the value of its inventories for other purposes in the manner indicated below, without violating the conformity requirements of section 472(c) and (e) of the Internal Revenue Code of 1954.

The taxpayer employs the LIFO inventory method for Federal income tax purposes and in all reports of income to shareholders, partners, other proprietors, beneficiaries and for credit purposes. Inventory increments are priced based on the earliest acquisition costs during the year. In past years, the taxpayer has consistently used a more inclusive method than required under section 1.471-11(a) of the regulations in determining inventoriable costs. Specifically, the taxpayer has treated pension contributions representing past service costs as inventoriable costs. Under section 1.471-11(c)(2)(ii)(*k*), such costs are not required to be included with inventoriable costs under the full absorption method for Federal income tax purposes, regardless of their treatment by a taxpayer in his financial statements. The taxpayer proposes to change its costing method for tax purposes to exclude such past service costs that are not required to be included under section 1.471-11(c)(2)(ii)(*k*). The taxpayer will comply with all requirements to obtain permission to make the transition to the full absorption method of inventory costing in accordance with section 1.471-11(e)(4)(i). However, the taxpayer contends that it should not be required to make such a change for financial statement purposes, since it is not using a method other than the LIFO inventory method in its financial statements.

Section 472(b)(1) of the Code provides that goods in the ending inventory shall be treated as composed first of goods included in the opening inventory (in the order of acquisition) to the extent thereof and then of goods acquired in the taxable year. Section 472(b)(3) provides that goods in the opening inventory for the taxable year of adoption shall be treated as having been acquired at the same time and their costs determined under the average cost method. Section 472(b)(2) requires a taxpayer to value its inventory at cost.

Section 472(c) of the Code provides that a taxpayer must not have used any procedure other than that specified in sections 472(b)(1) and (3) in inventorying goods included within the LIFO election to ascertain the income, profit, or loss for the first taxable year for the purpose of a report or statement to shareholders, proprietors, beneficiaries, or creditors. Section 472(e)(2), which refers only to section 472(b)(1), imposes a similar requirement for inventorying goods included within the election for subsequent taxable years and provides that the Secretary of the Treasury or the Secretary's delegate may require a change to a different method if such requirement is not met.

Section 1.471-11(e)(1)(i) of the regulations provides, in part, that a taxpayer not using the full absorption method of inventory costing as prescribed in section 1.471-11(a) must change to that method. The full absorption method is a method of determining the cost of the inventory, while the LIFO method is a method of carrying the inventory at cost.

Section 1.471-11(c)(3)(ii) of the regulations provides rules that may result in differences between the cost of inventoriable goods on the taxpayer's financial statements and the cost of the same goods under the full absorption method for Federal income tax purposes. Such rules are consistent with section 472(c) and (e) of the Code.

The conformity requirements of section 472 of the Code state that a taxpayer using the LIFO inventory method for Federal income tax purposes may not use a method other than the LIFO method for financial reporting or other purposes. The taxpayer's change of its costing method for tax purposes to exclude past service costs under section 1.471-11(c)(2)(ii)(*k*) of the regulations does not affect the sequential layering provisions of section 472(b)(1) and (3), and therefore does not result in the use of a method other than the LIFO method, nor is its use inconsistent with the use of the LIFO method.

Accordingly, in the instant case, the taxpayer will be permitted to change to the full absorption method of costing its LIFO inventory for Federal income tax purposes and to continue to value its LIFO inventories for financial statement purposes in a manner different from its tax reporting method without violating the conformity requirements of section 472(c) and (e) of the Code.

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26 CFR 1.472-2: Requirements incident to adoption and use of LIFO inventory method.

LIFO; financial conformity requirements. A taxpayer may disclose in a footnote in its annual financial statements the impact of year-end LIFO cost estimates made in interim financial statements that subsequently proved to be erroneous without violating the conformity requirements of section 472(c) and (e)(2) of the Code.

Rev. Rul. 76-475

Advice has been requested whether a taxpayer may disclose in its annual financial statements the impact of estimates made in interim financial statements that subsequently proved to be erroneous, without violating the conformity requirements of section 472(c) and (e)(2) of the Internal Revenue Code of 1954.

The taxpayer uses the last-in, first-out (LIFO) inventory method as provided in section 472 of the Code. The taxpayer reported its interim earnings on the LIFO inventory method using

an estimate of year-end LIFO costs. This estimate subsequently proved to be erroneous and the taxpayer included in its annual financial statements a footnote that disclosed the impact of this erroneous estimate. The language in the footnote was substantially similar to the following:

> LIFO inventories at December 31, 1975, were greater than originally projected during the year. If the 1975 interim results were adjusted to reflect the actual level of inventories at December 31, 1975, the earnings per share for the first three quarters would have been higher than originally reported by $XX, $XX, and $XX, respectively, and fourth quarter earnings lower by $X.

The taxpayer used only the LIFO inventory method in all other portions of its annual financial statements.

Section 472(c) of the Code provides that a taxpayer must not have used any procedure other than the LIFO procedure in inventorying goods included within the LIFO election to ascertain the income, profit, or loss for the first taxable year it uses the LIFO method for the purpose of reports to shareholders, proprietors, beneficiaries or creditors.

Section 472(e)(2) of the Code imposes substantially the same requirement as section 472(c) on subsequent taxable years, and authorizes the Secretary of the Treasury or the Secretary's delegate to require the taxpayer to change to another method of inventory identification and valuation when this requirement has not been met.

In the instant case, because the taxpayer did not use a method other than the LIFO inventory method in its annual and interim financial statements, the disclosure does not indicate the effect of using a different accounting method.

Accordingly, the footnote in the taxpayer's annual financial statements may be used without violating the conformity requirements of section 472(c) and (e)(2) of the Code.

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26 CFR 1.472-2: Requirements incident to adoption and use of LIFO inventory method.
(Also Section 471; 1.471-11.)

LIFO; allocation of cost variances to inventory; financial conformity. A LIFO electing taxpayer's allocation of significant production cost variances to inventory for federal income tax purposes and the deduction of such variances for financial reporting purposes does not result in a violation of the conformity requirements of section 472(c) and (e) of the Code.

Rev. Rul. 76-531

Advice has been requested whether, under the circumstances described below, the allocation of production cost variances to inventory, for Federal income tax purposes, pursuant to section 1.471-11(d)(3)(ii)(a) of the Income Tax Regulations, and the deduction of such variances for financial reporting purposes is a violation of sections 472(c) and (e) of the Internal Revenue Code of 1954.

The taxpayer is a corporation engaged in the manufacture and sale of electric appliances. The taxpayer uses the accrual method of accounting and files its returns on a calendar year basis. The taxpayer values its inventory at cost and employs the last-in, first-out (LIFO) inventory method.

For taxable years ended before 1975, the taxpayer did not employ the full absorption method of inventory costing within the meaning of 1.471-11 of the regulations. The taxpayer used a standard cost system to allocate production costs to inventory. Before 1975, all variances from standard cost were reflected in the cost of goods sold for both tax and financial reporting purposes resulting in current deductions.

The taxpayer elected, pursuant to section 1.471-11(e)(1)(ii) of the regulations, to change to the full absorption method of inventory costing, for its 1975 calendar year. Under the full absorption method, the taxpayer was required to allocate to ending inventory a pro rata portion of the variances from standard costs that were reflected in cost of goods sold because such variances were significant in amount. However, the taxpayer continued to reflect the variances in cost of goods sold for financial reporting purposes.

Section 1.471-11(d)(3)(ii)(a) of the regulations provides, in part, that the proper use of the standard cost method requires that a taxpayer must allocate to the goods in ending inventory a pro rata portion of any net negative or net positive overhead variances and net negative or net positive direct production variances. If such variances are not significant in amount in relation to the taxpayer's total actual indirect production costs for the year, then such variances need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial reports.

In describing the LIFO inventory method, section 472(b) of the Code prescribes the procedure that must be followed by a taxpayer in inventorying goods.

Sections 472(c) and (e) of the Code and sections 1.472-2(e) and (g) of the regulations require that a taxpayer adopting the LIFO inventory method must not have used any other inventory method in ascertaining income, profit, or loss for the taxable year in which LIFO method was first adopted or in any subsequent taxable year for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or the Commissioner may require the taxpayer to change to another method of accounting for Federal income tax purposes if it has used any other method of reporting its income for these purposes.

In the instant case, the taxpayer's treatment of the above costs in the manner described, does not result in the use of an inventory method other than the LIFO inventory method, as described in section 472(b) of the Code, because the difference in the

treatment of variances from standard costs does not result in the taxpayer's use of "any other inventory method" as such phrase is used in section 472 (c). *See* Rev. Rul. 76-379, page 138, this Bulletin.

Accordingly, in the instant case, the required allocation by the taxpayer to inventories, for Federal income tax purposes, of significant production cost variances pursuant to section 1.471-11 (d)(3)(ii) of the regulations and the deduction of such variances for financial reporting purposes does not result in a violation by the taxpayer of the conformity requirements of sections 472(c) and (e) of the Code.

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26 CFR 1.472-2: Requirements incident to adoption and use of LIFO inventory method.

Application of section 1.472-2 of the regulations, concerning inventory write-downs, to the use of the last-in, first-out (LIFO) inventory method. See Rev. Proc. 76-28, page 645.

Part III.—Adjustments

Section 481.—Adjustments Required By Changes In Method of Accounting

26 CFR 1.481-1: Adjustments in general.

Whether investment tax credit is allowable to a taxpayer for costs of labor and material incident to the installation of depreciable assets prior to 1974, when the taxpayer voluntarily requested, in accordance with sections 446 and 481 of the Code, a change in method of accounting from deducting installation costs to capitalizing installation costs beginning with taxable year 1974. See Rev. Rul. 76-437, page 12.

Section 482.—Allocation of Income and Deductions Among Taxpayers

26 CFR 1.482-1: Allocation of income and deductions among taxpayers.

Effect of an allocation of income from a foreign subsidiary to a domestic parent upon the credit for foreign income taxes deemed paid under section 902(a) of the Code where an income tax treaty provides for Competent Authority consideration. See Rev. Rul. 76-508, page 225.

Subchapter F.—Exempt Organizations
Part I.—General Rule

Section 501.—Exemption from Tax on Corporations, Certain Trusts, Etc.

26 CFR 1.501(a)-1: Exemption from taxation.

Procedures with respect to applications for recognition of exemption from income tax and revocation or modification of exemption rulings and determination letters under section 501 of the Code. See Rev. Proc. 76-33, page 655.

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26 CFR 1.501(c)(2)-1: Corporations organized to hold title to property for exempt organizations.

Title-holding corporation subsidiary. An organization incorporated as a subsidiary of an exempt title-holding corporation for the exclusive purpose of holding title to investment property, collecting the income therefrom, and turning over such income, less expenses, to the parent, qualifies for exemption under section 501(c)(2) of the Code.

Rev. Rul. 76-335

Advice has been requested whether the organization described below is exempt from Federal income tax under section 501(c)(2) of the Internal Revenue Code of 1954.

For good business reasons, the organization was incorporated as a subsidiary of Corporation *X*, a title-holding company exempt from Federal income tax under section 501(c)(2) of the Code, for the exclusive purpose of holding title to investment property that would otherwise be held by Corporation *X*. All of the stock of the organization is held by Corporation *X* and all of its income, less expenses, will be distributed to Corporation *X* at least annually. Corporation *X* will, in turn, distribute the income to its parent organization, which is exempt from Federal income tax under section 501(c)(3).

Section 501(c)(2) of the Code provides for the exemption from Federal income tax of corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from Federal income tax under section 501(a).

Section 1.501(c)(2)-1 of the Income Tax Regulations states that an organization cannot be exempt under section 501(c)(2) of the Code if it engages in any business other than that of holding title to property and collecting income therefrom. In addition, the regulation states that an organization described in section 501 (c)(2) cannot accumulate income and retain its exemption, but must turn over the entire amount of such income, less expenses, to an organization which is itself exempt from tax under section 501(a).

Since the subject organization merely holds title to investment property for, and turns over the income therefrom to, its parent, which is an organization exempt under section 501(a) of the Code, and since it otherwise satisfies the requirements of the pertinent provisions of the Code and regulations, it is exempt from Federal income tax under section 501 (c)(2).

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1024, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(2) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See section 1.501(a)-1 of the regulations.

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26 CFR 1.501(c)(3)-1: Organizations, organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the

prevention of cruelty to children or animals.
(Also Section 513; 1.513-1).

Unrelated income; commercially sponsored research. Commercially sponsored research otherwise qualifying as scientific research under section 501(c)(3) of the Code, the results of which, including all relevant information, are timely published in such form as to be available to the interested public, constitutes scientific research carried on in the public interest. Research, the publication of which is withheld or delayed significantly beyond the time reasonably necessary to establish ownership rights, however, is not in the public interest and constitutes the conduct of unrelated trade or business within the meaning of section 513.

Rev. Rul. 76-296

Advice has been requested whether the commercially sponsored scientific research in the situations described below is scientific research carried on in the public interest within the meaning of section 501(c)(3) of the Internal Revenue Code of 1954; and, if it is not, whether the carrying on of such sponsored research by an organization exempt from Federal income tax under section 501(c)(3) is the conduct of unrelated trade or business within the meaning of section 513.

The organization that performs the research is one that otherwise qualifies as a scientific organization exempt from Federal income tax under section 501(c)(3) of the Code. As part of its activities, the organization regularly undertakes what is termed "commercially sponsored scientific research," which is scientific research undertaken pursuant to contracts with private industries. Under the contracts for such research, the sponsor pays for the research and receives the right to the results of the research and all the ownership rights in patents resulting from work on the project.

Situation 1.

The results of the commercially sponsored projects, including all relevant information, are generally published in such form as to be available to the interested public either currently, as developments in the project warrant, or within a reasonably short time after completion of the project. If patent rights are involved, publication is delayed pending reasonable opportunity to establish such rights, such as through the filing of application for patents.

Situation 2.

On occasion, however, the organization will agree, at the request of the sponsor to forego publication of the results of a particular project in order to protect against disclosure of processes or technical data which the sponsor desires to keep secret for various business reasons. In other instances, the organization may agree to extend delay in the publication of results in cases in which the sponsor, for business reasons, desires to protect its patent rights under the project, but desires to defer initiation of patent procedures so as to delay or control the timing of public disclosure of the results of the project.

Section 501(c)(3) of the Code provides for exemption from Federal income tax of organizations organized and operated exclusively for scientific purposes.

Under section 1.501(c)(3)-1(d)(5)(i) of the Income Tax Regulations, an organization may meet the requirements of section 501(c)(3) of the Code only if it serves a public rather than a private interest. Because a "scientific" organization must be organized and operated in the public interest, the regulations further provide that the term "scientific," as used in section 501(c)(3), includes the carrying on of scientific research in the public interest.

Section 1.501(c)(3)-1(d)(5)(iii) of the regulations provides that scientific research will be regarded as carried on in the public interest if (*a*) the results of such research (including any patents, copyrights, processes, or formulae resulting therefrom) are made available to the public on a nondiscriminatory basis; (*b*) such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or (*c*) such research is directed toward benefiting the public.

This section of the regulations further provides that scientific research will be considered as directed toward benefiting the public, and, therefore, regarded as carried on in the public interest if it is carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public. In addition, the regulations explicitly provide that such research will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.

Thus, commercially sponsored scientific research that otherwise qualifies as scientific research under section 501(c)(3) of the Code and that meets the publication test of the regulations constitutes scientific research carried on in the public interest. To meet the test, the publication must be adequate and timely. Some public disclosure beyond that which flows naturally from the issuance of a patent is required. In addition, the publication must disclose substantially all of the information concerning the results of the research which would be useful or beneficial to the interested public.

Although the timing of the publication may vary depending upon the circumstance, the publication must be

reasonably prompt because the public disclosure as an addition to the body of useful scientific knowledge is the reason for considering the activity as directed toward benefiting the public. It should be noted that section 102 of Title 35 of the United States Code provides, in effect, that the right to a patent may be lost by publication of a description of the invention in a printed publication more than twelve months prior to the date of the application for the patent. Since the regulations recognize the right of the sponsor to obtain patents or copyrights resulting from the research, publication is not required in advance of the time at which it can be made public without jeopardy to the sponsor's right by reasonably diligent action to secure any patents or copyrights resulting from the research. However, adequate publication of the results of the research should be made as promptly after the completion of the research as is reasonably possible without jeopardizing the sponsor's right to secure patents or copyrights necessary to protect its ownership or control of the results of the research.

The "publication test" is satisfied in *Situation 1* because the results of the commercially sponsored research, including all relevant information, are not withheld beyond the time reasonably necessary to obtain patents or copyrights. Therefore, the scientific research is carried on for the purpose of obtaining scientific information which is published in some form available to the interested public. Since such research is regarded as carried on in the public interest even though it is performed pursuant to a contract under which the sponsor has the right to obtain ownership of the patent, it constitutes scientific research in the public interest within the meaning of section 501(c)(3) of the Code.

With respect to *Situation 2,* however, in which publication of the results of commercially sponsored scientific research is withheld entirely or delayed significantly beyond the time reasonably necessary to establish patent or other ownership rights in the results of the research in order to accommodate the sponsor's business interest in maintaining the secrecy of certain processes or to control the timing of public disclosure of the results, the requirements of the publication test are not met. The research connected with such projects, therefore, is not scientific research carried on in the public interest within the meaning of section 501(c)(3) of the Code.

The term "unrelated trade or business" is defined in section 513 of the Code to mean, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purposes or functions.

Section 1.513-1(d)(2) of the regulations provides that trade or business is substantially related to purposes for which exemption is granted if the production or distribution of the goods or the performance of the services from which the gross income is derived contributes importantly to the accomplishment of those purposes.

The organization, by agreeing to undertake commercially sponsored scientific research in the manner described above in *Situation 2,* is engaging in activity which is not exclusively scientific within the meaning of section 501(c)(3) of the Code and the regulations. Such activity, other than through the production of income, does not contribute importantly to the purposes for which exemption is granted to the organization.

Accordingly, the carrying on of the sponsored research in the manner described in *Situation 2* is the conduct of unrelated trade or business within the meaning of section 513.

26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

College student housing. A nonprofit organization formed to provide housing for students of a college unable to provide adequate student housing and located in a community in which suitable housing is not otherwise available is operated exclusively for charitable purposes and qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 76-336

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, is operated exclusively for charitable purposes.

The organization is a nonprofit corporation formed to provide housing for students of a particular college. The organization was formed by community leaders in response to studies by staff members of the college and the community leaders that determined that the community in which the college is located does not have suitable housing available at a reasonably affordable rent to meet the needs of the college or its student body. The college itself provides no housing facilities because it is financially unable to do so. As its enrollment has grown, however, many of the students in its primary service area live at such a distance that daily commuting is not reasonably possible.

The organization operates a housing facility for students adjacent to the college campus. All students of the college are eligible to apply for the housing. Applications for housing are accepted on a first come-first served basis. Charges to students for the housing approximate costs, including debt

retirement. The organization is not controlled by the student residents or by the college. However, the college and the organization consult and cooperate to ensure that the needs of the college and its students are served by the operation of the housing facility. The organization is governed by a board of directors composed of community leaders.

The organization's income is from rentals of the housing facilities and from contributions. Its disbursements are for operating expenses and debt retirement.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" as used in section 501(c)(3) of the Code includes the advancement of education.

The organization provides needed student housing that is not otherwise available. All students who attend the college are eligible to apply for residence. Under these circumstances, the organization is both helping the college, which is unable to provide adequate student housing, to fulfill its educational purposes, and aiding the students to attain an education. Therefore, the activities of the organization are advancing education. See Rev. Rul. 67-217, 1967-2 C.B. 181.

Accordingly, the organization is operated exclusively for charitable purposes and qualifies for exemption from Federal income tax under section 501(c)(3) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See sections 1.501(a)-1 and 1.508-1(a) of the regulations.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Investment clubs. An association of investment clubs formed to enable members and prospective investors to make sound investments by the mutual exchange of investment information, that carries on not only educational activities but other activities directed to the support and promotion of the economic interests of its members, does not qualify for exemption under section 501(c)(3) of the Code.

Rev. Rul. 76-366

Advice has been requested whether the nonprofit organization described below qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

The organization is an association of investment clubs formed for the mutual exchange of investment information among its members and prospective investors to enable them to make sound investments.

The association engages in the following activities:

(a) Prepares and publishes teaching aids for the use of its member clubs;

(b) Conducts workshops, seminars, and courses at which manuals designed for the review of securities and especially suited for investment club requirements are distributed to members and prospective investors;

(c) Sponsors lectures at which qualified experts discuss topics relating to the management of a stock portfolio;

(d) Arranges field trips to business offices, factories, banks, and stock exchanges;

(e) Publishes a monthly newsletter of interest to individual investors;

(f) Encourages and aids in the formation of new investment clubs;

(g) Establishes and enforces standards for the operation of investment clubs;

(h) Issues certificates of qualification to investment personnel who are capable of organizing and operating new clubs; and

(i) Provides individual clubs with technical advice on their organizational, bookkeeping, and operational problems.

The association supports itself with receipts from four sources: (1) membership dues; (2) fees for organizing and chartering investment clubs; (3) annual service fees for the operation of the association's educational programs; and (4) income from publications.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable or educational purposes.

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations provides that an organization is not organized or operated for exempt purposes unless it serves a public rather than a private interest.

The term "educational" is used in section 501(c)(3) of the Code in its general legal sense in the law of charities and does not have a separate and distinct meaning from the term "charitable."

In construing the meaning of the phrase "exclusively for educational purposes" in *Better Business Bureau v. United States,* 326 U.S. 279 (1945), Ct. D. 1650, 1945 C.B. 375, the Supreme Court of the United States said, "This plainly means that the presence of a single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."

While some of the association's ac-

tivities are educational, and of the kind that might be carried on by an organization described in section 501 (c) (3) of the Code, many of the activities listed above are directed in whole or in part to the support and promotion of the economic interests of the investment clubs that comprise its membership. These activities are not in furtherance of charitable and educational purposes. Further, by furnishing information to prospective investors to enable them to make sound investments, the association is serving private interests. Thus, the organization's purposes, not only as declared but also as evidenced by its activities, are not exclusively educational.

Accordingly, the association is not organized and operated exclusively for charitable and educational purposes, and thus does not qualify for exemption from Federal income tax under section 501(c) (3) of the Code.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Home repair loans to low income homeowners. A nonprofit organization that provides interest-free home repair loans in a badly deteriorated urban residential area to low-income homeowners who are unable to obtain loans elsewhere qualifies for exemption under section 501(c)(3) of the Code as operated exclusively for charitable purposes.

Rev. Rul. 76-408

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c) (3) of the Internal Revenue Code of 1954, is operated exclusively for charitable purposes.

The organization was created to promote the rehabilitation of a badly deteriorated residential area within a large city. The median income level within the area is lower than the median income level of other sections of the city. In furtherance of its purpose, the organization provides small, short-term, interest-free loans to homeowners in the area. Homeowners use the loans to make repairs to their homes that are necessary to meet local housing code regulations. In order to obtain a loan from the organization, homeowners must qualify under low income standards as determined by an appropriate government agency and show that they are unable to obtain a loan elsewhere. The organization periodically reviews the work on the repairs to assure that the funds are used for the stated purpose.

Section 501(c) (3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c) (3)-1(d) (2) of the Income Tax Regulations defines the term "charitable" as used in section 501(c) (3) of the Code as including the relief of the poor and distressed.

Situation 1, Rev. Rul. 70-585, 1970-2 C.B. 115, holds that an organization that rehabilitates homes for sale to low income families who cannot qualify for any type of mortgage qualifies for exemption because it is relieving the poor and distressed.

By providing interest-free home repair loans to low income homeowners under the circumstances described above, the organization is relieving the poor and distressed. Accordingly, the organization is operated exclusively for charitable purposes and is exempt from Federal income tax under section 501(c) (3) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c) (3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which the principal place of business or principal office of the organization is located. See sections 1.501(a)-1 and 1.508-1(a) of the regulations.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Community welfare; reduction of vehicle deaths and injuries. A nonprofit organization formed to initiate and develop plans and programs to reduce vehicle deaths and injuries by providing free expert opinions to local government officials regarding hazardous traffic conditions in the community and conducting programs designed to inform the public about traffic safety qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 76-418

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c) (3) of the Internal Revenue Code of 1954, is operated exclusively for charitable and educational purposes.

The organization was formed to initiate and develop plans and programs to reduce vehicle deaths and injuries. It is governed by a board of directors that consists of individuals from various segments of the public at large. To accomplish its objective, the organization provides local government officials, upon their request, with free expert opinions regarding the existence of hazardous traffic conditions in their particular communities. This service is performed by a staff of experts hired by the organization, and is designed to locate and identify traffic conditions that could lead to harmful accidents. After the organization has conducted an analysis of traffic conditions in a

community, it prepares a formal report detailing the existence of any hazardous conditions, and the dangerous effect that may be expected to result if the conditions are not corrected. This report also recommends ways in which the hazardous conditions may be remedied.

In addition to providing the services described above, the organization conducts for community groups lectures and other programs that are designed to inform the public on how to be alert and safe drivers and pedestrians. It also distributes free of charge pamphlets and brochures that explain how to recognize certain hazardous traffic conditions and how they may be corrected.

The income of the organization is derived from contributions from the general public.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable or educational purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations states that the term "charitable" is used in its generally accepted legal sense, and includes lessening of the burdens of government.

Section 1.501(c)(3)-1(d)(3) of the regulations defines the term "educational" as including the instruction of the public on subjects useful to the individual and beneficial to the community.

The performance of certain services for the benefit of Federal, state, or local governments has been recognized as a charitable activity. See Rev. Rul. 71-99, 1971-1 C.B. 151. Traffic control and safety are universally recognized as a governmental responsibility. By providing expert opinions to local government officials regarding the existence of hazardous traffic conditions in their communities, the organization is lessening the burdens of government and thus is engaged in a charitable activity within the meaning of the regulations. See Rev. Rul. 70-79, 1970-1 C.B. 127. Moreover, the lectures and other programs conducted by the organization as well as the distribution of materials relating to hazardous traffic conditions are educational, since they are designed to instruct the public on a subject useful to the individual and beneficial to the community.

Accordingly, the organization qualifies for exemption from Federal income tax under section 501(c)(3) of the Code as a charitable and educational organization.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See sections 1.501(a)-1 and 1.508-1(a) of the regulations.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Community welfare; industrial parks in depressed area. A nonprofit organization that purchases blighted land in an economically depressed community, converts the land into an industrial park, and encourages industrial enterprises to locate new facilities in the park in order to provide employment opportunities for low income residents of the area, is operated exclusively for charitable purposes and qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 76-419

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, is operated exclusively for charitable purposes.

The organization's objectives are the relief of conditions of poverty, dependency, chronic unemployment, and underemployment, and the reduction of community tensions in an economically depressed community. In furtherance of these purposes the organization encourages industrial enterprises to locate new facilities in the economically depressed area in order to provide more employment opportunities for low-income residents of this area.

The organization purchases blighted land in the area and converts it into an industrial park. Lots in the park are leased to industrial enterprises on terms sufficiently favorable to attract tenants to this economically depressed area. Tenants are required by their leases with the organization to hire a significant number of presently unemployed persons in the area and to train them in needed skills. In order to achieve the greatest community benefit, the organization, in selecting tenants for the industrial park, considers only those industrial enterprises whose hiring policies conform to current fair employment legislation. Enterprises having initial requirements for low skill workers are favored over those with initial high skill job requirements, since the former are of greater immediate benefit to the surrounding depressed community.

The organization is funded by the Economic Development Administration of the United States Department of Commerce pursuant to Public Law 90-222, Part D, Section 150, which provides for the establishment of special programs of sufficient size and scope to have an appreciable impact in low-income areas in arresting tendencies toward dependency, chronic unemployment, and rising community tensions. Pursuant to the terms of Public Law 90-222, the area in which the organization is active has been identified as such an area by appropriate governmental authorities. It has a high

ratio of unemployed and underemployed low-income people and is an area of urban blight consisting primarily of junk yards and vacant land with little industry.

The facts relating to the activities undertaken by the organization in carrying out its program establish that the activities are not undertaken with any motive or purpose of profit or gain but solely for the purpose of advancing the organization's declared objectives and goals.

Section 501(c)(3) of the Code provides for exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" includes the promotion of social welfare by organizations designed to relieve the poor and distressed, to lessen neighborhood tensions, or to combat community deterioration.

Rev. Rul. 74-587, 1974-2 C.B. 162, holds that a nonprofit organization formed to relieve poverty, eliminate prejudice, reduce neighborhood tensions, and combat community deterioration through a program of financial assistance designed to improve economic conditions and opportunities in high density urban areas inhabited primarily by low-income minority or other disadvantaged groups qualifies for exemption under section 501(c)(3) of the Code. The financial assistance provided was in the form of low-cost or long-term loans to, or the purchase of temporary equity interests in, business enterprises otherwise unable to obtain funds from conventional commercial sources due to their location in depressed urban communities or the proprietor's membership in a minority or other disadvantaged group.

By inducing industrial enterprises to locate in an economically depressed area and to hire and train the underemployed and unemployed in that area, the subject organization is similarly devoting its resources to uses that benefit the community in ways the law regards as charitable. The organization's activities serve not only to relieve poverty, but also to lessen neighborhood tensions caused by the lack of jobs and job opportunities in the area. Further, by creating an industrial park out of a blighted area, the organization is combatting community deterioration.

Accordingly, the organization qualifies for exemption from Federal income tax under section 501(c)(3) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See sections 1.501(a)-1 and 1.508-1(a) of the regulations.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

For-profit school converted to nonprofit school. An otherwise qualifying nonprofit organization that purchases or leases at fair market value the assets of a former for-profit school and employs the former owners, who are not related to the current directors, at salaries commensurate with their responsibilities is operated exclusively for educational and charitable purposes. An organization that takes over a school's assets and its liabilities, which exceed the value of the assets and include notes owed to the former owners and current directors of the school, is serving the directors' private interests and is not operated exclusively for educational and charitable purposes.

Rev. Rul. 76-441

Advice has been requested whether the nonprofit organizations described below, which otherwise qualify for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, are operated exclusively for charitable and educational purposes.

Situation 1.

X is the successor nonprofit organization to a former for-profit school. *X* purchased all of the for-profit school's personal property and leased the land and buildings from the former owners of the for-profit school. The personal property was purchased at fair market value and the rental of the leased facilities is at a fair market rental.

The former owners of the for-profit school are employed by *X* to reside at the school on a 24 hour basis and provide supervision and care of the students. The salaries paid to the former owners are commensurate with their responsibilities and are reasonable compensation for their services.

None of *X*'s officers or directors is related by blood or marriage to the former owners, nor is any of them a business associate of the former owners.

Situation 2.

Y, a nonprofit organization, received all of the stock in a for-profit school as a gift. *Y* dissolved the for-profit school and assumed all of its liabilities, including notes owed to the former owners. The financial information indicates that the liabilities of the for-profit school exceeded the fair market value of its assets. *Y*'s Board of Directors is composed of the former owners of the stock of the for-profit school.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable

and educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations provides that an organization is not organized and operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet this requirement, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

In *Situation 1*, *X* purchased the former school's personal property at fair market value in an arm's length transaction and is paying a fair rental value for the use of the land and buildings. *X* has also established that it pays the former owners of the for-profit school reasonable compensation for their services.

Accordingly, *X* has established that it is operated to serve a public rather than a private interest. Therefore, *X* is operated exclusively for educational and charitable purposes and qualifies for exemption from Federal income tax under section 501(c)(3) of the Code.

In *Situation 2*, however, the Directors of *Y* benefitted in their individual capacities from *Y*'s acceptance of a transfer of the stock in the for-profit school and its assumption of all the pre-existing liabilities thereof in connection with its subsequent liquidation. Since these liabilities included the notes owed to such directors and the liabilities of the for-profit school exceeded the fair market value of its assets, the nonprofit school is substantially serving the directors' private interests in honoring them. The directors were, in fact, dealing with themselves and will benefit financially from the transaction. Therefore, *Y* is not operated exclusively for educational and charitable purposes and does not qualify for exemption from Federal income tax under section 501(c)(3) of the Code.

Even though an organization considers itself within the scope of *Situation 1* of this Revenue Ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See sections 1.508-1(a) and 1.501(a)-1 of the regulations.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Free legal services for personal tax and estate planning. A nonprofit organization whose primary activity is the offering of free legal services for personal tax and estate planning to individuals who wish to make current and deferred gifts to charity as part of their overall tax and estate planning does not qualify for exemption under section 501(c)(3) of the Code.

Rev. Rul. 76-442

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, is operated exclusively for charitable purposes.

The organization's stated purpose is to encourage individuals to donate funds to charitable organizations. The primary activity of the organization is the offering of free legal services for personal tax and estate planning to individuals who wish to make current and deferred gifts to charity as part of their overall tax and estate planning. The organization itself is not affiliated with any particular charitable organization but rather encourages the client to provide for charities of personal interest. The legal services are provided by the organization's staff of attorneys. Although clients are generally not indigent, the organization does not require any payment for its services. Its main source of funds is from public contributions. Expenditures are for salaries and office expenses.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations provides that an organization is not organized or operated exclusively for an exempt purpose unless it serves a public rather than a private interest.

Section 1.501(c)(3)-1(d)(2) of the regulations provides a definition of the term "charitable." It is used in its generally accepted legal sense and includes relief of the poor and distressed and promotion of social welfare through charitable activities.

Aiding individuals in their tax and estate planning is not a charitable activity in the generally accepted legal sense. The organization is providing commercially available services to individuals who can afford them. Although funds may ultimately be made available to charity as a result of the organization's planning assistance to individuals, the benefits to the public are tenuous in view of the predominantly private purpose served by arranging individuals' tax and estate plans. The fact that gifts to charity are contemplated in the plans drawn up does not convert the assistance into a charitable activity or one that promotes social welfare within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations.

Accordingly, the organization is not

operated exclusively for charitable purposes and does not qualify for exemption from Federal income tax under section 501(c)(3) of the Code.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Noncommercial educational television programs. A nonprofit organization that makes facilities and equipment available to the general public for the production of noncommercial educational or cultural television programs for communication to the public via public and educational channels of a commercial cable television company qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 76-443

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, is operated exclusively for educational purposes.

The organization was formed for the purpose of making available to the general public facilities and equipment for the production of television programs intended for communication to the public via the public and educational access channels of a commercial cable television company. The organization accepts applications from individuals and groups who wish to use its facilities and equipment to produce programs for broadcast over the access channels.

The organization screens the applications to ensure that the programs to be produced will be of an educational or a cultural nature. Advertising material designed to promote the sale of commercial products or services and endorsements of candidates for political office are prohibited under Federal Communications Commission regulations on any of these access channels.

Additionally, the organization does not accept applications involving programs that support or oppose specific legislation, and, in instances where a particular viewpoint is to be advocated, the organization screens the applications to ensure that the programs will present a full and fair exposition of the pertinent facts so as to permit an individual or the public to form an independent opinion or conclusion, and will not be the mere presentation of unsupported opinion.

Usually, the organization collects a nominal fee from persons who use its equipment and facilities. However, no application is denied because of the applicant's inability to pay. The organization receives most of its support from government and foundation grants and contributions from the general public. Its board of directors is composed of individuals with extensive experience in broadcasting and the visual arts.

The organization is informally affiliated with, but does not control and is not controlled by, the commercial cable television company.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for educational purposes.

Section 1.501(c)(3)-1(d)(3) of the Income Tax Regulations provides that the term "educational," as used in section 501(c)(3) of the Code, relates to the instruction of the public on subjects useful to the individual and beneficial to the community. An example of an educational organization described in the regulations is one whose activities include public discussions, forums, lectures, panels and other similar programs. Such programs may be on radio or television.

Rev. Rul. 66-220, 1966-2 C.B. 209, holds that a nonprofit corporation organized and operated exclusively for educational purposes to operate a noncommercial educational broadcasting station presenting educational, cultural and public interest programs is exempt from Federal income tax under section 501(c)(3) of the Code.

Rev. Rul. 67-342, 1967-2 C.B. 187, holds that a nonprofit organization which produces educational films concerning a particular subject and which disseminates its educational material to the public by means of commercial television may qualify for exemption under section 501(c)(3) of the Code where the films are presented in a noncommercial manner.

Rev. Rul. 76-4, 1976-1 C.B. 145, holds that a nonprofit organization that produces and distributes free (or at small cost-defraying fees) educational, cultural, and public interest programs for public viewing via public-educational channels of commercial cable television companies is operated exclusively for educational purposes and is exempt from Federal income tax under section 501(c)(3) of the Code, and that any private benefit to the commercial cable television companies is outweighed by the direct benefit to the general public.

These Revenue Rulings clearly indicate that an organization may achieve its educational purposes through the production of television programs, regardless of whether the programs are to be broadcast over the airwaves or over a cable system, so long as the programs are presented in a noncommercial manner. The absence of commercial advertising is a key factor in determining the noncommercial nature of the programming activity. With regard to programs prepared for cable television, the Federal Communications Commission regulations prohibit cable operators from commercially advertising on their educational or "public access" channels.

By providing members of the general public with the opportunity to produce television programs of an educational or a cultural nature for viewing on the public access channels of a

commercial cable television company, in the manner described above, the organization is operating exclusively for educational purposes. Accordingly, it is exempt from Federal income tax under section 501(c)(3) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the District in which is located the principal place of business or principal office of the organization. See sections 1.501(a)-1 and 1.508-1(a) of the regulations.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Promoting improvements in health care and facilities. A nonprofit organization formed to encourage and assist in establishment of nonprofit regional health data systems, to conduct studies and propose improvements with regard to quality, utilization, and effectiveness of health care and health care agencies, and to educate those involved in furnishing, administering, and financing health care is operated exclusively for scientific and educational purposes and qualifies for exemption under section 501 (c)(3) of the Code; Rev. Rul. 74-553 distinguished.

Rev. Rul. 76-455

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, is operated exclusively for scientific and educational purposes.

The organization was organized to encourage and assist in the establishment of nonprofit regional health data systems, to conduct scientific studies with regard to the quality, utilization, and effectiveness of health care agencies, to educate those involved in furnishing, administering, and financing health care as to the deficiencies in the quality, utilization, and effectiveness of health care and health care agencies, and to make proposals to remedy such deficiencies.

The information compiled by the organization provides data which is useful for a number of purposes, including, but not limited to, reviewing patient management patterns, planning for regional and community health needs, and conducting epidemiological research. The organization offers and furnishes aid in the development and establishment of uniform health data record-keeping and reporting procedures to provide compatibility of data. It conducts scientific studies on means and methods of effectively analyzing the quality and use of health care systems. It also conducts an educational program in conjunction with its annual meeting. All of the services of the organization are made available to health care institutions, governmental bodies, and the general public, without charge, and on a nondiscriminatory basis. By providing these services the organization seeks to increase the efficiency and reduce the cost of health care. The organization has no regulatory authority.

Membership in the organization is composed of active and associate members. Each of its active members is a nonprofit operator of a regional health data collection program which cooperates with the health care agencies in a geographically identifiable area and regularly disseminates regional health data for that area. Associate members are hospital associations, medical associations, medical record associations, health insurance associations, hospital accreditation associations, and other organizations that are interested in furthering the objectives of the organization.

The organization is financed by membership dues and grants from organizations and governmental agencies. Its expenses are incurred in holding the annual meeting, including seminars lectures, and conferences, and in administering its programs.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for scientific or educational purposes.

Section 1.501(c)(3)-1(d)(3) of the Income Tax Regulations defines the term "educational," as used in section 501(c)(3) of the Code, as relating to the instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.501(c)(3)-1(d)(5) of the regulations states that the term "scientific," as used in section 501(c)(3) of the Code, includes the carrying on of scientific research in the public interest. Scientific research will be regarded as carried on in the public interest if such research is directed toward benefitting the public.

An organization that employs a professional research staff to conduct social science research under contracts with governmental agencies and makes the results of that research avaliable to the public through seminar courses and other comparable means qualifies for exemption as an educational and scientific organization described in section 501(c)(3) of the Code. See Rev. Rul. 65-60, 1965-1 C.B. 231.

An organization formed to develop scientific methods for the diagnosis, prevention, and treatment of diseases, and to disseminate the results of its developmental work to members of the medical profession and the general public qualifies under section 501(c)(3) of the Code. See Rev. Rul. 65-298, 1965-2 C.B. 163.

By improving and enlarging the body of knowledge concerning current

usage of health facilities and methods of treatment, the organization seeks to create a more efficient use of the nation's health facilities, and to aid in the planning of better care for future health needs.

The organization is distinguishable from the one considered in Rev. Rul. 74-553, 1974-2 C.B. 168. That Revenue Ruling holds that a nonprofit organization formed by members of a state medical association to operate peer review boards and carry on other related research and oversight functions for the primary purpose of establishing and maintaining standards for quality, quantity, and reasonableness of cost of medical services qualifies for exemption under section 501(c)(6) of the Code, but not under section 501(c)(3).

The organization in question, on the other hand, is exclusively concerned with the research and study of existing health care facilities, the dissemination of the results of such studies, and the discovery or determination of methods and practices that will provide better medical services to the general public. While such research and study does have an indirect relationship to the ultimate costs of medical services, the research and study are not carried on to set standards for or to police the industry but to provide educational and scientific benefits to the general public.

Accordingly, the organization is operated exclusively for educational and scientific purposes and thus qualifies for exemption from Federal income tax under section 501(c)(3) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the corporation. See section 1.501(a)-1 and 1.508-1(a) of the regulations.

Rev. Rul. 74-553 is distinguished.

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26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Political campaign practices. An organization formed to elevate the standards of ethics and morality in the conduct of political campaigns that disseminates information concerning general campaign practices, furnishes teaching aids to political science and civics teachers, and publicizes its proposed code of fair campaign practices without soliciting the signing or endorsement of the code by candidates qualifies as an educational organization under section 501(c)(3) of the Code. Rev. Rul. 66-258 modified and superseded for taxable years beginning after 1976.

Rev. Rul. 76-456

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, is operated exclusively for educational purposes.

The organization was formed for the purpose of elevating the standards of ethics and morality that prevail in the conduct of campaigns for election to public office at the national, state, and local levels. In furtherance of this purpose, the organization, on a nonpartisan basis, collects, collates, and disseminates information concerning general campaign practices through the press, radio, television, mail, and public speeches. In addition, the organization furnishes "teaching aids" to political science and civics teachers to help stress the need for ethical conduct in political campaigns.

The organization has proposed a code of fair campaign practices. Although need for the code is extensively publicized, the organization does not solicit the signing or endorsement of the code by candidates for political office.

The organization's receipts are derived mainly from contributions or grants. A small percentage of its income is derived from the sale of its literature.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for educational purposes which do not participate or intervene in (including the publishing or distributing of statements) any political campaign on behalf of any candidate for public office.

Section 1.501(c)(3)-1(c)(3)(iii) of the Income Tax Regulations provides that an organization is an "action" organization, and thus not operated exclusively for educational purposes, if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office. Activities which constitute participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to, the publication or distribution of written or printed statements or the making of oral statements on behalf of or in opposition to such a candidate.

Section 1.501(c)(3)-1(d)(3) of the regulations provides that the term "educational", as used in section 501(c)(3) of the Code, relates to the instruction of the public on subjects useful to the individual and beneficial to the community.

The organization is instructing the public on subjects useful to the individual and beneficial to the community within the meaning of section 1.501(c)(3)-1(d)(3) of the regulations by encouraging voters to concern themselves with fair as well as unfair practices encountered in political cam-

paigns. This is done, on a nonpartisan basis, so that citizens may increase their knowledge and understanding of our election processes and participate more effectively in their selection of government officials. Accordingly, the organization is operated exclusively for educational purposes and thus qualifies for exemption from Federal income tax under section 501(c)(3) of the Code.

The organization described above is identical to the organization described in Rev. Rul. 66-258, 1966-2 C.B. 213, except that it does not solicit the signing or endorsement of its code of fair campaign practices by candidates for political office. Rev. Rul. 66-258 is modified to the extent that it implies that the organization described therein qualifies under section 501(c)(3) of the Code even though it directly approaches candidates for public office and asks that they sign or endorse the code. Such activity constitutes participation or intervention in a political campaign and may result, through the publication or release of the names of candidates who sign or endorse or who refuse to sign or endorse the code, in influencing voter opinion. Since such activity is prohibited by section 1.501(c)(3)-1(c)(3)(iii) of the regulations, an organization engaging in such activity will not qualify under section 501(c)(3) of the Code.

Rev. Rul. 66-258 is modified and, as modified, is superseded since this position is restated in this Revenue Ruling. Rev. Rul. 60-193, 1960-1 C.B. 195, which was originally modified by Rev. Rul. 66-258, remains modified to the extent that it holds that the activities described therein could not qualify as educational within the meaning of section 501(c)(3) of the Code.

Pursuant to the authority contained in section 7805(b) of the Code, this Revenue Ruling will not be applied to taxable years beginning before January 1, 1977.

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26 CFR 1.501(c)(5)-1: Labor, agricultural, and horticultural organizations.

Agricultural; negotiating crop prices with processors. A nonprofit organization of growers and producers of a particular agricultural commodity formed principally to negotiate with processors for the price to be paid to members for their crops qualifies for exemption under section 501(c)(5) of the Code.

Rev. Rul. 76-399

Advice has been requested whether the nonprofit organization described below qualifies for exemption from Federal income tax under section 501(c)(5) of the Internal Revenue Code of 1954 as an agricultural organization.

The organization was formed by persons engaged in growing and producing a particular agricultural commodity. Its principal purpose is to negotiate with processors for the price to be paid to members for their crops. Although the prices negotiated by the organization may be incorporated into the contracts between the individual members and the processors, the members are free to negotiate prices on their own. All of the mechanics of harvesting, inspecting, delivering, and paying for the crops are handled by arrangements between the members and the processors; the organization neither assists nor engages in any of these activities. The organization does not receive any portion of the processors' payments to the members, but receives all of its support from membership dues.

Section 501(c)(5) of the Code provides for the exemption from Federal income tax of labor, agricultural, and horticultural organizations.

Section 1.501(c)(5)-1 of the Income Tax Regulations provides that organizations contemplated by section 501(c)(5) of the Code are those that have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of their products, and the development of a higher degree of efficiency in their respective occupations.

By negotiating the price of crops with processors, the organization has as its objective the betterment of the conditions of the growers and producers. Compare Rev. Rul. 74-118, 1974-1 C.B. 134, which holds that an organization of farmers' wives that participates in and supports activities designed to obtain higher prices for farm products qualifies for exemption under section 501(c)(5) of the Code.

The activities of the subject organization are distinguishable from those of the organization described in Rev. Rul. 66-105, 1966-1 C.B. 145, which holds that a nonprofit agricultural corporation whose principal activity is marketing livestock as agent for its members does not qualify for exemption under section 501(c)(5) of the Code. In this case, the organization's activities are limited to negotiating a price satisfactory to its members. It is not engaged in any other activities that foster or assist the members' sale of their crops. The organization is neither responsible for actually entering into a sales contract nor obligated to perform any acts necessary to consummate the sale of crops.

Accordingly, the organization qualifies for exemption from Federal income tax under section 501(c)(5) of the Code as an agricultural organization.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1024, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(5) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See section 1.501(a)-1 of the regulations.

26 CFR 1.501(c)(5)-1: Labor, agricultural, and horticultural organizations.

Labor; strike pay. An organization, controlled by private individuals, that provides weekly income to its members in the event of a lawful strike by the member's labor union in return for an annual payment by the member does not qualify for exemption as a labor organization under section 501(c)(5) of the Code.

Rev. Rul. 76-420

Advice has been requested whether the nonprofit organization described below qualifies for exemption from Federal income tax under section 501 (c) (5) of the Internal Revenue Code of 1954.

The organization solicits members from the memberships of various labor unions. In return for an annual payment, it contracts to pay a weekly income up to a fixed number of weeks to a member in the event of a lawful strike by the member's union. It is controlled by private individuals and not by any labor organization exempt under section 501(c)(5) of the Code. Its receipts are from the annual payments made by its members and its disbursements are for strike pay to members and administrative expenses.

Section 501(c)(5) of the Code provides for the exemption from Federal income tax of labor organizations.

Section 1.501(c)(5)-1(a) of the Income Tax Regulations provides that the labor organizations contemplated by section 501(c)(5) of the Code are those which have no net earnings inuring to the benefit of any member and have as their objects the betterment of the conditions of those engaged in labor, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

Because the organization has no authority to represent or speak for its members in matters relating to their employment, such as wages, hours of labor, working conditions, or economic benefits, it is not a "labor organization" in the commonly accepted sense of that term as it is used in section 501(c)(5) of the Code. *Portland Co-operative Labor Temple Association,* 39 B.T.A. 450 (1939), *acq.,* 1939-1 (Part 1) C.B. 28. The organization is controlled by private individuals and is not controlled by or connected with any of the labor organizations to which its members belong. It does not directly support the efforts of any labor organization to better employment conditions. Further, while the organization is operated for the purpose of providing payments of weekly income to workers in the event of a lawful strike by the worker's union, it does not make these payments with the objective of bettering conditions of employment, but by reason of its contractual agreements with the workers. Accordingly, the organization does not qualify for exemption from Federal income tax as a labor organization described in section 501(c)(5) of the Code.

Compare Rev. Rul. 67-7, 1967-1 C.B. 137, which holds that an organization controlled by a labor union exempt under section 501(c)(5) of the Code and providing financial assistance to the members of that union during strikes and lockouts may be exempt as a labor organization described in section 501(c)(5).

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26 CFR 1.501(c)(6)-1: Business leagues, chambers of commerce, real estate boards, and boards of trade.

Business league; organization of business and professional women. A nonprofit organization formed as a membership organization of business and professional women that promotes the acceptance of women in business and the professions qualifies for exemption under section 501(c)(6) of the Code.

Rev. Rul. 76-400

Advice has been requested whether the nonprofit organization described below qualifies for exemption from Federal income tax as a business league under section 501(c)(6) of the Internal Revenue Code of 1954.

The organization was formed as a membership organization of business and professional women to promote the acceptance of women in business and the professions.

The activities of the organization include sponsoring conventions, luncheons, and dinner meetings that are devoted to the discussion, review, and consideration of problems relating to career opportunities for women and various issues centering around attitudes towards women in business. Additionally, the organization awards scholarships to female students and presents a young-woman-of-the-month award.

Section 501(c)(6) of the Code provides for the exemption from Federal income tax of business leagues not organized for profit, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(6)-1 of the Income Tax Regulations defines a business league as an association of persons having some common business interest, the purpose of which is to promote such common interest and to improve conditions in one or more lines of business.

Rev. Rul. 74-147, 1974-1 C.B. 136, and the decision in the case of *Associated Industries of Cleveland,* 7 T.C. 1449 (1946), *acq.,* 1947-1 C.B. 1, hold that organizations dealing with common business interests and fulfilling the other requirements of section 501 (c)(6) of the Code qualify for exemption under such section.

Here, the common business interest of the members is dealing with the unique problems that women in business have encountered that are not ordinarily encountered by their male counterparts. Thus, by sponsoring luncheons, dinner meetings, and con-

ventions that are devoted to the discussion and consideration of problems affecting women in business and the professions, the organization is promoting a common business interest.

In addition to promoting the common business interest of its members, a business league exempt under section 501(c)(6) of the Code must also seek to improve conditions in one or more lines of business. Prior Revenue Rulings have recognized that a business league which restricts its membership in an attempt to secure a competitive advantage for its members will not qualify for exemption. See, e.g., Rev. Rul. 73-411, 1973-2 C.B. 180, and Rev Rul. 68-182, 1968-1 C.B. 263.

Although the organization in the instant case restricts its membership to women, its purpose is not limited to benefiting its members. Through its activities which promote the common business interest of its members, the organization also improves conditions in one or more lines of business as required by the regulations. To the extent that the organization achieves its goal of improving opportunities for and attitudes toward women, it improves conditions in each of the industries or lines of business from which its members are drawn.

Accordingly, the organization qualifies for exemption from Federal income tax under section 501(c)(6) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1024, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(6) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See section 1.501(a)-1 of the regulations.

26 CFR 1.501(c)(6)-1: Business leagues, chambers of commerce, real estate boards, and boards of trade.

Business leagues; directory of members published; franchises granted. A nonprofit organization of individuals in the business of furnishing finance adjusting services, which assigns exclusive franchise areas to its members and publishes and distributes to their potential customers a directory containing members' names and addresses, is performing particular services for its members and does not qualify for exemption under section 501(c)(6) of the Code.

Rev. Rul. 76-409

Advice has been requested whether the nonprofit organization described below qualifies for exemption from Federal income tax under section 501(c)(6) of the Internal Revenue Code of 1954.

The organization is a voluntary association of individuals engaged in the business of furnishing finance adjusting services to automobile finance companies, automobile dealers, and other organizations requiring such services. Membership consists of adjusters, investigators, repossessors, liquidators, and skip tracers. The organization was formed to provide a means for the membership to exchange views on their common business and legal problems, to maintain standards of ethical conduct within their profession, and to cooperate in promoting the public relations and general welfare of their profession.

Members are assigned franchise areas, usually a large city and the area within a seventy-five mile radius of the city. There is only one membership granted in each of these franchise areas.

The organization's principal activity is the publication and distribution of an annual directory consisting almost entirely of members' names, addresses, and telephone numbers. The directory is distributed free to those members of the business community who are likely to require the services of the profession. Listings in the directory are alphabetical by State and city, and include all cities, towns, or boroughs having a population of five thousand or more. The directory lists the member under the franchise city and then cross references each of the smaller localities within the franchise area to the franchise city.

The organization's activities also include holding a yearly convention; sponsoring a booth at various industry trade shows; continual policing of membership with respect to qualifications, effectiveness, and conformity to Federal, state, and local laws; publishing a monthly newsletter and listing of automobiles in the possession of persons who have skipped from the address given to the appropriate finance company; and providing a $10,000 bond to clients of members to indemnify them against losses caused by members in the performance of their services.

Section 501(c)(6) of the Code provides for the exemption from Federal income tax of business leagues not organized for profit, no part of the net earnings of which inures to the benefit of any shareholder or individual.

Section 1.501(c)(6)-1 of the Income Tax Regulations defines a business league as an association of persons having some common business interest. The activities of the association must be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

The publication and distribution, in the manner described above, of a directory containing the names and addresses of members constitutes advertising for the individuals so listed, and is, therefore, the performance of particular services for such individuals rather than an activity aimed at the

improvement of general business conditions. See Rev. Rul. 65-14, 1965-1 C.B. 236. The granting of specific territorial franchises to members and restricting membership on this basis benefits individual members to the exclusion of the finance adjusting industry as a whole. By publishing the annual directory, by assigning franchises to its members, and by providing its members with various other services, the organization is operated primarily to assist its members in their individual businesses rather than to improve the profession as a whole. Thus, the organization is primarily engaged in the performance of particular services for individual persons rather than the improvement of business conditions in one or more lines of business. Accordingly, the organization does not qualify for exemption from Federal income tax under section 501(c)(6) of the Code.

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26 CFR 1.501(c)(6)-1: Business leagues, chambers of commerce, real estate boards, and boards of trade.

Business leagues; insurance companies; no-fault protection. A nonprofit organization composed of insurance companies operating within a state and created under the state's no-fault insurance statute to provide personal injury protection benefits for residents of the state who sustain injury in situations where the injuring party is unknown or has very limited or no liability coverage qualifies for exemption under section 501(c)(6) of the Code.

Rev. Rul. 76-410

Advice has been requested whether the nonprofit organization described below qualifies for exemption from Federal income tax under section 501(c)(6) of the Internal Revenue Code of 1954.

The organization is a nonprofit association composed of insurance companies. It was created pursuant to a state's no-fault insurance statute to provide personal injury protection for certain residents of the state who might sustain injury and not be covered by any insurance.

The organization provides personal injury protection benefits to those residents of the state who suffer injury in situations where the injuring party has no liability insurance coverage or very limited coverage or the injuring party is unknown. For example, a resident pedestrian injured by an out-of-state uninsured motorist would not be covered by conventional policies under the state's no-fault law. Under the statute, however, the injured party is able to file a claim with the organization. The claim is registered and assigned to one of the organization's member companies, which is designated as a servicing member, to process and pay the claim. The servicing member is reimbursed by the organization for the amount paid plus expenses incurred.

Section 501(c)(6) of the Code provides for the exemption from Federal income tax of business leagues not organized for profit, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(6)-1 of the Income Tax Regulations defines a business league as an association of persons having some common business interest. The activities of the association must be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

The organization's activities promote the common business interests of its members by fulfilling an obligation that the state has imposed upon the insurance industry as a prerequisite for doing business within the state and by enhancing the image of the industry. Moreover, because every insurance company operating within the state is required to be a member, there is no competitive advantage gained by membership in the organization. All of the above factors indicate that the organization's activities are directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for its individual members. See Rev. Rul. 71-155, 1971-1 C.B. 152, and Rev. Rul. 73-452, 1973-2 C.B. 183. Accordingly, the organization is exempt from Federal income tax under section 501(c)(6) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1024, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(6) of the Code. The application should be filed with the District Director of Internal Revenue for the key district indicated in the instructions to the Form 1024. See section 1.501(a)-1 of the regulations.

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26 CFR 1.501(c)(8)-1: Fraternal beneficiary societies.
(Also 1.501(c)(10)-1.)

Fraternal beneficiary society; optional insurance. A domestic fraternal beneficiary society of farmers operated under the lodge system that does not itself provide for the payment of life, sick, accident, or other benefits to its members, but arranges with insurance companies to provide optional insurance to its members and devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes does not qualify for exemption under section 501(c)(8) of the Code but does qualify under section 501(c)(10).

Rev. Rul. 76-457

Advice has been requested whether the organization described below qualifies for exemption from Federal in-

come tax under section 501(c)(8) or section 501(c)(10) of the Internal Revenue Code of 1954.

The organization is a domestic fraternal society of farmers that is operated under the lodge system. The organization does not provide for the payment of life, sick, accident, or other benefits to its members. However, it has made arrangements with two independent insurance companies for the latter to provide insurance to those members of the organization who may want such insurance and who make application individually for their particular policies. One of the insurance companies provides policies such as fire and extended coverage, homeowners, farmowners, auto casualty, and farm and residence liability; the other provides life and disability insurance. The insurance provided does not accrue automatically to the members as part of the benefits for dues paid. Members may or may not, at their own option, purchase the insurance from these companies. About 60 percent of the members purchase insurance from these companies, and their payments are made to the insurance companies directly.

The organization's receipts consist primarily of annual dues from the members. The organization's expenses consist of general operating expenses, costs for the conduct of classes to provide guidance to its lodges on how to operate efficiently and effectively, costs for regional meetings, and costs arising from work with other farm organizations in support of rural improvements. Any net earnings are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.

Section 501(c)(8) of the Code provides for the exemption from Federal income tax of fraternal beneficiary societies, orders, or associations—

(A) Operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and

(B) Providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

Section 1.501(c)(8)-1 of the Income Tax Regulations provides, in part, that in order to be exempt under section 501(c)(8) of the Code, a fraternal beneficiary society must have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

In the instant case, while pursuant to the organization's arrangement with the insurance companies members of this organization are eligible for favorable insurance rates, the organization itself is not providing for, or underwriting, the life, sick, accident, or other benefits. The agreements are between the individual members and the insurance companies. Accordingly, the organization is not exempt from Federal income tax under section 501(c)(8) of the Code.

However, section 501(c)(10) of the Code provides for the exemption from Federal income tax of domestic fraternal societies, orders, or associations, operating under the lodge system—

(A) The net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and

(B) Which do not provide for the payment of life, sick, accident, or other benefits.

Section 1.501(c)(10)-1 of the regulations provides that an organization will qualify for exemption under section 501(c)(10) of the Code if it—

(1) Is a domestic fraternal beneficiary society, order, or association described in section 501(c)(8) and the regulations thereunder except that it does not provide for the payment of life, sick, accident, or other benefits to its members, and

(2) Devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.

The organization described above is a domestic fraternal society that would be described in section 501(c)(8) of the Code except that it does not provide for the payment of life, sick, accident, or other benefits to its members. It does, however, devote its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes. Accordingly, the organization is exempt from Federal income tax under section 501(c)(10) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1024, Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(10) of the Code. The application should be filed with the District Director of Internal Revenue for the key district indicated in the instructions to Form 1024. For group exemption procedures, see Rev. Proc. 72-41, 1972-2 C.B. 820.

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26 CFR 1.501(c)(10)-1: Certain fraternal beneficiary societies.

Whether a domestic fraternal beneficiary society of farmers operated under the lodge system that does not itself provide for payments of life, sick, accident, or other benefits to its members or their dependents, but that devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, or fraternal purposes qualifies for exemption under section 501(c)(10) of the Code. See Rev. Rul. 76-457, page 155.

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26 CFR 1.501(c)(19)-1: War veterans organizations.
(Also Section 512; 1.512(a)-4.)

T.D. 7438[1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

War Veterans Organizations

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

[1] This publication of the Treasury Decision contains the full text of the regulations. The individual instructions for modifying the notice of proposed rulemaking have been omitted.

Preamble

This document finalizes amendments to the Income Tax Regulations (26 CFR Part 1) under sections 501(c)(19) and 512(a)(4) of the Internal Revenue Code of 1954, relating to war veterans organizations, which were published in proposed form in the Federal Register on June 16, 1975 (40 F.R. 25476).

The reason for these amendments is to make changes in the regulations under section 501(c)(19) and section 512(a)(4), so as to reflect the revision of sections 501 and 512 by the Act of August 29, 1972 (P.L. 92-418, 86 Stat. 656) [1972-2 C.B. 675]; exempting certain war veterans organizations from income tax; and exempting from the unrelated business income tax certain insurance set asides of such organizations.

Adoption of amendments to the regulations

In view of the foregoing, and after consideration of all such relevant material as was presented by interested persons regarding the proposed rules, the following amendments of the regulations are hereby adopted:

Paragraph 1. The following new sections are added immediately after § 1.501(c)(18)-1:

§ 1.501(c)(19) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; war veterans organizations.

Sec. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* The following organizations are referred to in subsection (a):

* * * * *

(19) A post or organization of war veterans, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization—

(A) Organized in the United States or any of its possessions,

(B) At least 75 percent of the members of which are war veterans and substantially all of the other members of which are individuals who are veterans (but not war veterans), or are cadets, or are spouses, widows, or widowers of war veterans or such individuals, and

(C) No part of the net earnings of which inures to the benefit of any private shareholder or individual.

[Sec. 501(c)(19) as added by the Act of August 29, 1972 (Pub. Law 92-418, 86 Stat. 656)].

§ 1.501(c)(19)-1 War veterans organizations.

(a) *In general.* (1) For taxable years beginning after December 31, 1969, a veterans post or organization which is organized in the United States or any of its possessions may be exempt as an organization described in section 501(c)(19) if the requirements of paragraphs (b) and (c) of this section are met, if no part of its net earnings inures to the benefit of any private shareholder or individual, and if it does not participate directly or indirectly in political campaigns on behalf of or in opposition to any candidate for public office. Paragraph (b) of this section contains the membership requirements such a post or organization must meet in order to qualify under section 501(c)(19). Paragraph (c) of this section outlines the purposes, at least one of which such a post or organization must have in order to so qualify.

(2) In addition, an auxiliary unit or society described in paragraph (d) of this section of such a veterans post or organization and a trust or foundation described in paragraph (e) of this section for such post or organization may be exempt as an organization described in section 501(c)(19).

(b) *Membership requirements.* (1) In order to be described in section 501(c)(19) under paragraph (a)(1) of this section, an organization must meet the membership requirements of section 501(c)(19)(B) and this paragraph. There are two requirements that must be met under this paragraph. The first requirement is that at least 75 percent of the members of the organization must be war veterans. For purposes of this section the term "war veterans" means persons, whether or not present members of the United States Armed Forces, who have served in the Armed Forces of the United States during a period of war (including the Korean and Vietnam conflicts).

(2) The second requirement of this paragraph is that at least 97.5 percent of all members of the organization must be described in one or more of the following categories:

(i) War veterans,

(ii) Present or former members of the United States Armed Forces,

(iii) Cadets (including only students in college or university ROTC programs or at Armed Services academies), or

(iv) Spouses, widows, or widowers of individuals referred to in paragraph (b)(2)(i), (ii) or (iii) of this section.

(c) *Exempt purposes.* In addition to the requirements of paragraphs (a)(1) and (b) of this section, in order to be described in section 501(c)(19) under paragraph (a)(1) of this section an organization must be operated exclusively for one or more of the following purposes:

(1) To promote the social welfare of the community as defined in § 1.501(c)(4)-1(a)(2),

(2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents, and the widows and orphans of deceased veterans,

(3) To provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States.

(4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors.

(5) To conduct programs for religious, charitable, scientific, literary, or educational purposes,

(6) To sponsor or participate in activities of a patriotic nature,

(7) To provide insurance benefits for their members or the dependents of their members or both, or

(8) To provide social and recreational activities for their members.

(d) *Auxiliary units or societies for war veterans organizations.* A unit or society may be exempt as an organization described in section 501(c)(19) and paragraph (a)(2) of this section if it is an auxiliary unit or society of a post or organization of war veterans described in paragraph (a)(1) of this section. A unit or society is an auxiliary unit or society of such a post or organization if it meets the following requirements:

(1) It is affiliated with, and organized in accordance with, the bylaws and regulations formulated by an organization described in paragraph (a)(1) of this section,

(2) At least 75 percent of its members are either war veterans, or spouses of war veterans, or are related to a war veteran within two degrees of consanguinity (*i.e.,* grandparent, brother, sister, grandchild represent the most distant allowable relationships),

(3) All of its members are either members of an organization described in paragraph (a)(1) of this section, or spouses of a member of such an organization or are related to a member of such an organization, within two degrees of consanguinity, and

(4) No part of its net earnings inures to the benefit of any private shareholder or individual.

(e) *Trusts or foundations.* A trust or foundation may be exempt as an organization described in section 501(c)(19) and paragraph (a)(2) of this section if it is a trust or foundation for a post or organization of war veterans described in paragraph (a)(1) of this section. A trust or foundation is a trust or foundation for such a post or organization if it meets the following requirements:

(1) The trust or foundation is in existence under local law and, if organized for charitable purposes, has a dissolution provision described in § 1.501(c)(3)-1(b)(4),

(2) The corpus or income cannot be diverted or used other than for the funding of a post or organization of war veterans described in paragraph (a)(1) of this section, for section 170(c)(4) purposes, or as an insurance set aside (as defined in § 1.512(a)-4(b)).

(3) The trust income is not unreasonably accumulated and, if the trust or foundation is not an insurance set aside, a substantial portion of the income is in fact distributed to such post or organization or for section 170(c)(4) charitable purposes, and

(4) It is organized exclusively for one or more of those purposes enumerated in paragraph (c) of this section.

Par. 2. Section 1.512(a)-1 is amended by revising paragraph (a) to read as follows:

§ 1.512(a)-1 Definition.

(a) *In general.* Except as otherwise provided in § 1.512(a)-3, § 1.512(a)-4, or paragraph (f) of this section, section 512(a)(1) defines "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in § 1.512(b)-1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in paragraph (d)(2) of this section, to be "directly connected with" the conduct of unrelated business for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities.

* * * * *

Par. 3. Section 1.512(a) is amended by adding a new paragraph (4) to section 512(a) and by revising the historical note. The new provisions read as follows:

§ 1.512(a) Statutory provisions; unrelated business taxable income; special rule applicable to organizations described in section 501(c)(19).

Sec. 512. *Unrelated business taxable income*—(a) For purposes of this title—

* * * * *

(4) *Special rule applicable to organizations described in section 501(c)(19).* In the case of an organization described in section 501(c)(19), the term "unrelated business taxable income" does not include any amount attributable to payments for life, sick, accident, or health insurance with respect to members of such organization or their dependents which is set aside for the purpose of providing for the payment of insurance benefits or for a purpose specified in section 170(c)(4). If an amount set aside under the preceding sentence is used during the taxable year for a purpose other than a purpose described in the preceding sentence, such amount shall be included, under paragraph (1), in unrelated business taxable income for the taxable year.

[Sec. 512(a)(4) as added by the Act of August 29, 1972 (Public Law 92-418, 86 Stat. 656)].

Par. 4. A new § 1.512(a)-4 is added immediately before § 1.512(b) to read as follows:

§ 1.512(a)-4 Special rules applicable to war veterans organizations.

(a) *In general.* For taxable years beginning after December 31, 1969, this section provides special rules for the determination of the unrelated business taxable income of an organization described in section 501(c)(19). In general, the rules contained in sections 511 through 514 which are applicable to any organization listed

in section 501(c) apply in determining the unrelated business taxable income of an organization described in section 501(c)(19). However, that amount which is paid by members to the organization for the purpose described in paragraph (b)(1) of this section, if set aside from other organizational monies and accounts in an insurance set aside, may be excluded from the unrelated business taxable income of the organization. The insurance set aside shall be used exclusively for providing insurance benefits, for the purposes specified in section 170(c)(4) of the Code, for the reasonable costs of administering the insurance program that are directly related to such set aside, or for the reasonable costs of distributing funds for section 170(c)(4) purposes. If an amount so set aside is used for any purposes other than those described in the preceding sentence, it shall be included in unrelated business taxable income without regard to any modifications provided by section 512(b), in the taxable year in which it is withdrawn from such set aside. Amounts will be considered to have been withdrawn from an insurance set aside if they are used in any manner inconsistent with providing insurance benefits, paying the reasonable costs of administering the insurance program, for section 170(c)(4) purposes, and for costs of distributing funds for section 170(c)(4) purposes. An example of a use of funds which would be considered a withdrawal would be the use of such funds as security for a loan.

(b) *Insurance set aside.* (1) *Purpose of payments by members.* Payments by members (including commissions on such payments earned by the set aside as agent for an insurance company) into an insurance set aside must be for the sole purpose of obtaining life, sick, accident or health insurance benefits from the organization or for the reasonable costs of administration of the insurance program, except that such purpose is not violated when excess funds from an experience gain are utilized for those purposes specified in section 170(c)(4) or the reasonable costs of distributing funds for such purposes. Funds for any other purpose may not be set aside in the insurance set aside.

(2) *Income from set aside.* In addition to the payments by members described in paragraph (b)(1) of this section, only income from amounts in the insurance set aside (including commissions earned as agent for an insurance company) may be so set aside. Moreover unless such income is used for providing insurance benefits, for those purposes specified in section 170(c)(4), or for reasonable costs of administration, such income must be set aside within the period described in paragraph (b)(3) of this section in order to avoid being included as an item of unrelated business taxable income under section 512(a)(4).

(3) *Time within which income must be set aside.* Income from amounts in the insurance set aside generally must be set aside in the taxable year in which it would be includible in gross income but for this section. However, income set aside on or before the date prescribed for filing the organization's return of unrelated business taxable income (whether or not it had such income) for the taxable year (including any extension of time) may, at the election of the organization, be treated as having been set aside in such taxable year.

(4) *Computation of income from set aside.* Income from amounts in the insurance set aside shall consist solely of items of investment income from, and other gains derived from dealings in, property in the set aside. The deductions allowed against such items of income or other gains are those amounts which are related to the production of such income or other gains. Only the amounts of income or other gain which are in excess of such deductions may be set aside in the insurance set aside.

(5) *Requirements for set aside.* An amount is not properly set aside if the organization commingles it with any amount which is not to be set aside. However, adequate records describing the amount set aside and indicating that it is to be used for the designated purpose are sufficient. Amounts that are set aside need not be permanently committed to such use either under state law or by contract. Thus, for example, it is not necessary that the organization place these funds in an irrevocable trust. Although set aside income may be accumulated, any accumulation which is unreasonable in amount or duration is evidence that the income was not accumulated for the purposes set forth. For purposes of the preceding sentence, accumulations which are reasonably necessary for the purpose of providing life, sick, health, or accident insurance benefits on the basis of recognized mortality or morbidity tables and assumed rates of interest under an actuarially acceptable method would not be unreasonable even though such accumulations are quite large and the time between the receipt by the organization of such amounts and the date of payment of the benefits is quite long. For example, an accumulation of income for 20 years or longer which is determined to be reasonably necessary to pay life insurance benefits to members, their dependents or designated beneficiaries, generally would not be an unreasonable accumulation. Income which has been set aside may be invested, pending the action contemplated by the set aside, without being regarded as having been used for other purposes.

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved September 28, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 7, 1976; 8:45 a.m., and published in the issue of the Federal Register for October 8, 1976, 41 F.R. 44391)

Section 503.—Requirements for Exemption

26 CFR 1.503(a)-1: Denial of exemption to certain organizations engaged in prohibited transactions.

T.D. 7428

TITLE 26.—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; SUBCHAPTER B, PART 20.—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954; PART 25.—GIFT TAX, GIFTS MADE AFTER DECEMBER 31, 1954

Loss of exemption of certain exempt organizations under sections 503 and 504 of the Code

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

By a notice of proposed rule making appearing in the Federal Register for May 10, 1976 (41 F.R. 19115), amendments to the Income Tax Regulations (26 CFR Part 1), the Estate Tax Regulations (26 CFR Part 20), and the Gift Tax Regulations (26 CFR Part 25) were proposed in order to conform such regulations to provisions of section 101(j) of the Tax Reform Act of 1969 (83 Stat. 526) [Pub. L. 91-172, 1969-3 C.B. 10] and section 2003(b) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978) [Pub. L. 93-406, 1974-3 C.B.]. This document adopts those amendments without change.

The amendments to the regulations provide that section 503 (relating to prohibited transactions) does not apply to section 501(c)(3) organizations effective January 1, 1970, and to qualified retirement plans (other than certain church and government plans) effective January 1, 1975. Also the amendments reflect the repeal of section 504, effective January 1, 1970.

The amendments provide that those 501(c)(3) organizations that have lost their exemption under section 501(a) because of violation of section 503 or 504 during 1969 or a prior year do not cease to be described in section 501(c)(3). As a result of being described in section 501(c)(3), such organizations may be subject to the provisions of chapter 42 as private foundations. A loss of exemption, however, does mean that contributions to the organization are not to be treated as deductible charitable contributions until the organization has reapplied to the Commissioner for recognition of exemption. In addition, other technical and conforming amendments are adopted.

Adoption of amendments to the regulations

Based on the foregoing, the Income Tax Regulations (26 CFR Part 1), the Estate Tax Regulations (26 CFR Part 20), and the Gift Tax Regulations (26 CFR Part 25) are amended by adopting the proposed rules.

Paragraph 1. Section 1.101 is amended by revising section 101(b)(2)(B)(iii) and by revising the historical note. These amended provisions read as follows:

§ 1.101 Statutory provisions; certain death benefits.

Sec. 101 *Certain death benefits.* * * *

(b) *Employees' death benefits.* * * *

(2) *Special rules for paragraph (1).* * * *

(B) *Nonforfeitable rights.* * * *

(iii) Under an annuity contract purchased by an employer which is an organization referred to in section 170(b)(1)(A)(ii) or (vi) or which is a religious organization (other than a trust) and which is exempt from tax under section 501(a), but only with respect to that portion of such total distributions payable which bears the same ratio to the amount of such total distributions payable which is (without regard to this subsection) includible in gross income, as the amounts contributed by the employer for such annuity contract which are excludable from gross income under section 403(b) bear to the total amounts contributed by the employer for such annuity contract.

* * * * *

[Sec. 101 as amended by sec. 23(d), Technical Amendments Act 1958 (72 Stat. 1622) [Pub. L. 85-866, 1958-3 C.B. 254]; sec. 7(c), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 829) [Pub. L. 87-792, 1962-3 C.B. 258]; sec. 1(c), Act of March 8, 1966 (Pub. L. 89-365, 80 Stat. 32) [1966-1 C.B. 377]; sec. 101(j)(1), Tax Reform Act 1969 (83 Stat. 526) [Pub. L. 91-172, 1969-3 C.B. 10].]

Par. 2. Paragraph (d)(2) of § 1.101-2 is amended by revising so much of such paragraph as precedes the examples contained therein, and paragraph (d)(4) of § 1.101-2 is amended by revising paragraph (d)(4)(i)(*a*), paragraph (d)(4)(iv), the eighth sentence of example (1) of paragraph (d)(4)(v), and the fifth sentence of example (3) of paragraph (d)(4)(v) to read as follows:

§ 1.101-2 Employee's death benefits.

* * * * *

(d) *Nonforfeitable rights.* * * *

(2) The application of paragraph (d)(1) of this section may be illustrated by the following examples, in which it is assumed that the plans are not "qualified plans" and that no employer is an organization referred to in section 170(b)(1)(A)(ii) or (vi) or a religious organization (other than

a trust) which is exempt from tax under section 501(a):

* * * * *

(4)(i) * * *

(*a*) If such amounts are paid under an annuity contract purchased by an employer which is an organization referred to in section 170(b)(1)(A)(ii) or (vi) or which is a religious organization (other than a trust) and which is exempt from tax under section 501(a).

* * * * *

(iv) For purposes of this subparagraph, an annuity contract will be considered to have been purchased by an employer which is an organization referred to in section 170(b)(1)(A)(ii) or (vi) or which is a religious organization (other than a trust) and which is exempt from tax under section 501(a), if any of the contributions paid toward the purchase price of such contract by the employer were paid at a time when the employer was such an organization. Thus an annuity contract may be regarded as purchased by such an organization even though part of the organization's contributions for such annuity contract were paid at a time when the organization was not such an exempt organization.

* * * * *

(v) * * *

Example (1). * * * However, all the contributions paid by X Organization were paid at a time when X Organization was an organization referred to in section 170(b)(1)(A)(ii) and exempt from tax under section 501(a). * * *

* * * * *

Example (3). * * * However, all the contributions paid by Y Organization were paid at a time when it was an organization referred to in secton 170(b)(1)(A)(ii) and exempt from tax under section 501(a). * * *

Par. 3. Paragraph (b)(5) of § 1.401-1 is amended by deleting the last two sentences of paragraph (b)(5)(i) and by changing the first sentence of paragraph (b)(5)(ii) to read as follows:

§ 1.401-1 Qualified pension, profit sharing and stock bonus plans.

* * * * *

(b) *General rules.* * * *

(5) * * *

(ii) Where the trust funds are invested in stock or securities of, or loaned to, the employer or other person described in section 503(b), full disclosure must be made of the reasons for such arrangement and the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees. * * *

* * * * *

Par. 4. Paragraph (k) of § 1.401-12 is amended to read as follows:

§ 1.401-12 Requirements for qualification of trusts and plan benefiting owner-employees.

* * * * *

(k) *Contributions of property under a qualified plan.* (1) The contribution of property, other than money, prior to January 1, 1975, by the person who is the employer (within the meaning of section 401(c)(4)) to a qualified trust forming a part of a plan which covers employees some or all of whom are owner-employees who control (within the meaning of section 401(d)(9)(B) and the regulations thereunder) the trade or business with respect to which the plan is established is a prohibited transaction between such trust and the employer-grantor of such trust (see section 503(g) prior to its repeal by sec. 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978)) [Pub. L. 93-406, 1974-1 C.B.].

(2) A contribution of property, other than money, prior to January 1, 1975, to a qualified trust by an owner-employee who controls, or a member of a group of owner-employees who together control, the trade or business with respect to which the plan is established, or a contribution of property, other than money, to a qualified trust by a member of such an owner-employee's family (as defined in section 267(c)(4)), is a prohibited transaction. (See section 503(g) prior to its repeal by section 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978)) [Pub. L. 93-406, 1974-1 C.B.].

(3) See section 4975 and the regulations thereunder with respect to rules relating to the contribution of property, other than money, made after December 31, 1974.

Par. 5. Section 1.501(a) is amended by revising section 501(a) and by adding a historical note. The amended and added provisions read as follows:

§ 1.501(a) Statutory provisions; exemption from tax on corporations; certain trusts, etc.

Sec. 501. *Exemption from tax on corportations, certain trusts, etc.*—(a) *Exemption from taxation.* An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

[Sec. 501(a) as amended by sec. 101(j)(3), Tax Reform Act 1969 (83 Stat. 526) [Pub. L. 91-172, 1969-3 C.B. 10]]

Par. 6. Paragraph (a)(1) and (3) of § 1.501(a)-1 is amended to read as follows:

§ 1.501(a)-1 Exemption from taxation.

(a) *In general; proof of exemption.* (1) Section 501(a) provides an exemption from income taxes for organizations which are described in section 501(c) or (d) and section 401(a), unless such organization is a "feeder organization" (see section 502), or unless it engages in a transaction described in section 503. However, the exemption does not extend to "unrelated business taxable income" of such an organization (see part III (section 511 and following), subchapter F, chapter 1 of the Code).

* * * * *

(3) An organization claiming exemption under section 501(a) and described in any paragraph of section 501(c) (other than section 501(c)(1)) shall file the form of application prescribed by the Commissioner and shall include thereon such information as required by such form and the instructions issued with respect thereto. For rules relating to the obtaining of a determination of exempt status by an employees' trust described in section 401(a), see the regulations under section 401.

Par. 7. Section 1.501(b) is amended by revising section 501(b) and by adding a historical note. The amended and added provisions read as follows:

§ 1.501(b) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; tax on unrelated business income.

Sec. 501. *Exemption from tax on corporations, certain trusts, etc.* * * *

(b) *Tax on unrelated business income and certain other activities.* An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in parts II, III, and VI of this subchapter, but (notwithstanding parts II, III, and VI of this subchapter) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

[Sec. 501(b) as amended by sec. 101(j)(4), Tax Reform Act 1969 (83 Stat. 526) [Pub. L. 91-172, 1969-3 C.B. 10]; sec. 10(c), Act of Jan. 3, 1975 (Pub. L. 93-625, 88 Stat. 2119) [1975-1 C.B. 510]]

Par. 8. Paragraph (e)(3) of § 1.501(c)(3)-1 is deleted.

Par. 9. Section 1.501(c)(16) is amended by revising section 501(c)(16) and by adding a historical note. The amended and added provisions read as follows:

§ 1.501(c)(16) Statutory provisions; exemption from tax on corporations, certain trusts, etc.; corporations organized to finance crop operations.

Sec. 501 *Exemption from tax on corporations, certain trusts, etc.* * * *

(c) *List of exempt organizations.* * * *

(16) Corporations organized by an association subject to part IV of this subchapter or members thereof, for the purpose of financing the ordinary crop operations of such members or other producers, and operated in conjunction with such association. Exemption shall not be denied any such corporation *because* it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the corporation, on dissolution or otherwise, beyond the fixed dividends) is owned by such association, or members thereof; nor shall exemption be denied any such corporation because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

[Sec. 501(c)(16) as amended by sec. 101(j)(5), Tax Reform Act 1969 (83 Stat. 527) [Pub. L. 91-172, 1969-3 C.B. 10]]

Par. 10. Section 1.503(a) through § 1.503(j)-1 are amended to read as follows:

§ 1.503(a) Statutory provisions; requirements for exemption; denial of exemption to organizations engaged in prohibited transactions.

Sec. 503. *Requirements for exemption.*

(a) *Denial of exemption to organizations engaged in prohibited transaction*—(1) *General rule.* (A) An organization described in section 501(c)(17) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction after December 31, 1959.

(B) An organization described in section 401(a) which is referred to in section 4975(g)(2) or (3) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction after March 1, 1954.

(C) An organization described in section 501(c)(18) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transacton after December 31, 1969.

(2) *Taxable years affected.* An organization described in section 501(c)(17) or (18) or paragraph (a)(1)(B) shall be denied exemption from taxation under section 501(a) by reason of paragraph (1) only for taxable years after the taxable year during which it is notified by the Secretary or his delegate that it has engaged in a prohibited transaction, unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization.

[Sec. 503(a) as amended by sec. 2, Act of July 14, 1960 (Pub. L. 86-667, 74 Stat. 535) [1960-2 C.B. 687]; Secs. 101(j)(7) and (8) and 121(b)(6)(B), Tax Reform Act 1969 (83 Stat. 527, 542) [Pub. L. 91-172, 1969-3 C.B. 10]; sec. 2003(b)(1), (2), and (3), Employee Retirement Income Security Act 1974 (88 Stat. 978) [Pub. L. 93-406, 1974-1 C.B.]]

§ 1.503(a)-1 Denial of exemption to certain organizations engaged in prohibited transactions.

(a)(1) Prior to January 1, 1970, section 503 applies to those organizations described in sections 501(c)(3), 501(c)(17), and section 401(a) except—

(i) A religious organization (other than a trust);

(ii) An educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on;

(iii) An organization which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)) from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public;

(iv) An organization which is operated, supervised, controlled or principally supported by a religious organization (other than a trust) which is itself not subject to the provisions of this section; and

(v) An organization the principal purposes or functions of which are the providing of medical or hospital care or medical education or medical research or agricultural research.

(2) Effective January 1, 1970, and prior to January 1, 1975, section 503

shall apply only to organizations described in section 501(c)(17) or (18) or section 401(a).

(3) Effective January 1, 1975, section 503 shall apply only to organizations described in section 501(c)(17) or (18) or described in section 401(a) and referred to in section 4975(g)(2) or (3).

(b) The prohibited transactions enumerated in section 503(b) are in addition to and not in limitation of the restrictions contained in section 501(c)(3), (17), or (18) or section 401(a). Even though an organization has not engaged in any of the prohibited transactions referred to in section 503(b), it still may not qualify for tax exemptions in view of the general provisions of section 501(c)(3), (17), or (18) or section 401(a). Thus, if a trustee or other fiduciary of the organization (whether or not he is also a creator of such organization) enters into a transaction with the organization, such transaction will be closely scrutinized in the light of the fiduciary principle requiring undivided loyalty to ascertain whether the organization is in fact being operated for the stated exempt purpose.

(c) An organization—

(1) Described in section 501(c)(3) which after July 1, 1950, but before January 1, 1970, has engaged in any prohibited transaction as defined in section 503(b), unless it is excepted by the provisions of paragraph (a)(1) of this section;

(2) Described in section 401(a) and referred to in section 4975(g)(2) or (3) which after March 1, 1954, has engaged in any prohibited transaction as defined in section 503(b);

(3) Described in section 401(a) and not referred to in section 4975(g)(2) or (3) which after March 1, 1954, but before January 1, 1975, has engaged in any prohibited transaction as defined in section 503(b) or which after December 31, 1962, but before January 1, 1975, has engaged in any prohibited transaction as defined in section 503(g) prior to its repeal by section 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978) [Pub. L. 93-406, 1974-1 C.B.];

(4) Described in section 501(c)(17) which after December 31, 1959, has engaged in any prohibited transaction as defined in section 503(b); or

(5) Described in section 501(c)(18) which after December 31, 1969, has engaged in any prohibited transaction described in section 503(b);

shall not be exempt from taxation under section 501(a) for any taxable year subsqeuent to the taxable year in which there is mailed to it a notice in writing by the Commissioner that it has engaged in such prohibited transaction. Such notification by the Commissioner shall be by registered or certified mail to the last known name and address of the organization. However, notwithstanding the requirement of notification by the Commissioner, the exemption shall be denied with respect to any taxable year if such organization during or prior to such taxable year commenced the prohibited transaction with the purpose of diverting income or corpus from its exempt purposes and such transaction involved a substantial part of the income or corpus of such organization. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organizations means a calendar year. See 26 CFR § 1.503(j)-1 (rev. as of Apr. 1. 1974) for provisions relating to the definition of prohibited transactions in the case of trusts benefiting certain owner-employees after December 31, 1962, but prior to January 1, 1975. See also section 2003(c)(1)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978) [Pub. L. 93-406, 1974-1 C.B.] in the case of an organization described in section 401(a) with respect to which a disqualified person elects to pay a tax in the amount and manner provided with respect to the tax imposed by section 4975 of the Code so that the organization may avoid denial of exemption under section 503.

(d) The application of section 503(b) may be illustrated by the following examples:

Example (1). A creates a foundation in 1954 ostensibly for educational purposes. B, a trustee, accumulates the foundation's income from 1957 until 1959 and then uses a substantial part of this accumulated income to send A's children to college. The foundation would lose its exemption for the taxable years 1957 through 1959 and for subsequent taxable years until it regains its exempt status.

Example (2). If under the facts in example (1) such private benefit was the purpose of the foundation from its inception, such foundation is not exempt by reason of the general provisions of section 501(c)(3), without regard to the provisions of section 503, for all years since its inception, that is, for the taxable years 1954 through 1959 and subsequent taxable years, since under section 501(c)(3) the organization must be organized and operated exclusively for exempt purposes. See § 1.501(c)(3)-1.

§ 1.503(b) Statutory provisions; requirements for exemption; prohibited transactions.

Sec. 503. *Requirements for exemption.* * * *

(b) *Prohibited transactions.* For purposes of this section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this section—

(1) Lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

(2) Pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(3) Makes any part of its services available on a preferential basis to;

(4) Makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) Sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) Engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a

trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 267(c)(4)) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

[Sec. 503(b) as amended by sec. 101(j)(14), Tax Reform Act 1969 (83 Stat. 522) [Pub. L. 91-172, 1969-3 C.B. 10]]

§ 1.503(b)-1 Prohibited transactions.

(a) *In general.* The term "prohibited transaction" means any transaction set forth in section 503(b) engaged in by any organization described in paragraph (a) of § 1.503(a)-1. Whether a transaction is a prohibited transaction depends on the facts and circumstances of the particular case. This section is intended to deny tax-exempt status to such organizations which engage in certain transactions which inure to the private advantage of (1) the creator of such organization (if it is a trust); (2) any substantial contributor to such organization; (3) a member of the family (as defined in section 267(c)(4)) of an individual who is such creator of or such substantial contributor to such organization; or (4) a corporation controlled, as set forth in section 503(b), by such creator or substantial contributor.

(b) *Loans as prohibited transactions under section 503(b)(1)*—(1) *Adequate security.* For the purposes of section 503(b)(1), which treats as prohibited transactions certain loans by an organization without receipt of adequate security and a reasonable rate of interest, the term "adequate security" means something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. Mortgages or liens on property, accommodation endorsements of those financially capable of meeting the indebtedness, and stock or securities issued by corporations other than the borrower may constitute security for a loan to the persons or organizations described in section 503(b). Stock of a borrowing corporation does not constitute adequate security. A borrower's evidence of indebtedness, irrespective of its name, is itself not security for a loan, whether or not it was issued directly to the exempt organization. However, if any such evidence of indebtedness provides for security that may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, there may be adequate security for such loan. If an organization subject to section 503(b) purchases debentures issued by a person specified in section 503(b), the purchase is considered, for purposes of section 503(b)(1), as a loan made by the purchaser to the issuer on the date of such purchase. For example, if an exempt organization subject to section 503(b) makes a purchase through a registered security exchange of debentures issued by a person described in section 503(b), and owned by an unknown third party, the purchase will be considered as a loan to the issuer by the purchaser. For rules relating to loan of funds to, or investment of funds in stock or securities of, persons described in section 503(b) by an organization described in section 401(a), see paragraph (b)(5) of § 1.401-1.

(2) *Effective dates.* The effective dates for the application of the definition of adequate security in subparagraph (1) of this paragraph are:

(i) March 15, 1956, for loans (other than debentures) made after March 15, 1956;

(ii) January 31, 1957, for loans (other than debentures) made before March 16, 1956, and continued after January 31, 1957;

(iii) November 8, 1956, for debentures which were purchased after November 8, 1956;

(iv) December 1, 1958, for debentures which were purchased before November 9, 1956, and held after December 1, 1958;

(v) If an employees' pension, stock bonus, or profit-sharing trust described in section 401(a) made a loan before March 1, 1954, repayable by its terms after December 31, 1955, and which would constitute a prohibited transaction if made on or after March 1, 1954, the loan shall not constitute a prohibited transaction if held until maturity (determined without regard to any extension or renewal thereof);

(vi) January 1, 1960, for loans (including the purchase of debentures) made by supplemental unemployment benefit trusts, described in section 501(c)(17);

(vii) January 1, 1970, for loans (including the purchase of debentures) made by employees' contribution pension plan trusts described in section 501(c)(18).

(3) *Certain exceptions to section 503(b)(1).* See section 503(e) and §§ 1.503(e)-1, 1.503(e)-2, and 1.503(e)-3 for special rules providing that certain obligations acquired by trusts described in section 401(a) or section 501(c)(17) or (18) shall not be treated as loans made without the receipt of adequate security for purposes of section 503(b)(1). See section 503(f) and § 1.503(f)-1 for an exception to the application of section 503(b)(1) for certain loans made by employees' trusts described in section 401(a).

(c) *Examples.* The principles of this section are illustrated by the following examples: (Assume that section 503(e) and (f) are not applicable.)

Example (1). A, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his unsecured promissory note. The net worth of A is $1,000,000. The net worth of A is not "security" for such loan and the trans-

action is a prohibited transaction. If, however, the note is secured by a mortgage on property of sufficient value, or is accompanied by acceptable collateral of sufficient value, or carries with it the secondary promise of repayment by an accommodation endorser financially capable of meeting the indebtedness, it may be adequately secured. However, subordinated debenture bonds of a partnership which are guaranteed by the general partners are not adequately secured since the general partners are liable for the firm's debt and their guaranty adds no additional security.

Example (2). Assume the same facts as in example (1) except that A's promissory note in the amount of $100,000 to the trust is secured by property which has a fair market value of $75,000. A's promissory note secured to the extent of $75,000 is not adequately secured within the meaning of section 503(b)(1) since the security at the time of the transaction must be sufficient to repay the indebtedness, interest, and charges which may pertain thereto.

Example (3). Corporation M, a substantial contributor to an exempt organization subject to section 503, borrows $150,000 from such organization in 1960, giving its promissory note accompanied by stock of the borrowing corporation with a fair market value of $200,000. Since promissory notes and debentures have priority over stock in the event of liquidation of the corporation, stock of a borrowing corporation is not adequate security. Likewise, debenture bonds which are convertible on default into voting stock of the issuing corporation do not constitute "adequate security" under section 503(b)(1).

Example (4). B, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his secured promissory note at the rate of 3 percent interest. The prevailing rate of interest charged by financial institutions in the community where the transaction takes place is 5 percent for a loan of the same duration and similarly secured. The loan by the trust to the grantor is a prohibited transaction since section 503(b)(1) requires both adequate security and a reasonable rate of interest. Further, a promise to repay the loan plus a percentage of future profits which may be greater than the prevailing rate of interest does not meet the reasonable rate of interest requirement.

Example (5). N Corporation, a substantial contributor to an exempt organization subject to section 503 borrows $50,000 on or after March 16, 1956, from the organization. If the loan is not adequately secured, the organization has committed a prohibited transaction at the time the loan was made. If the loan had been made on or before March 15, 1956, and is continued after January 31, 1957, it must be adequately secured on February 1, 1957, or it will be considered a prohibited transaction on that date. However, if the exempt organization were an employees' trust, described in section 401(a), and the loan were made before March 1, 1954, repayable by its terms after December 31, 1955, it would not have to be adequately secured on February 1, 1957. Moreover, if the exempt organization were a supplemental unemployment benefit trust, described in section 501(c)(17), and the loan were made before January 1, 1960, repayable by its terms after December 31, 1959, it would not have to be adequately secured on January 1, 1960.

Example (6). An exempt organization subject to section 503 purchases a debenture issued by O Corporation, which is a substantial contributor to the organization. The organization purchases the debenture in an arm's length transaction from a third person on or after November 9, 1956. The purchase is considered as a loan by the organization to O Corporation. The loan must be adequately secured when it is made, or it is considered as a prohibited transaction at that time. If the organization purchased the debenture before November 9, 1956, and holds it after December 1, 1958, the debenture must be adequately secured on December 2, 1958, or it will then be considered as a prohibited transaction. However, if the organization were an employees' trust described in section 401(a), and if the debenture were purchased before March 1, 1954, and its maturity date is after December 31, 1955, the debenture does not have to be adequately secured. Moreover, if the organization were a employee's contribution pension plan trust described in section 501(c)(18), and if the debenture were purchased before January 1, 1970, and its maturity date is after December 31, 1969, the debenture does not have to be adequately secured.

§ 1.503(c) Statutory provisions; requirements for exemption; future status of organizations denied exemption.

Sec. 503. *Requirements for exemption.*
* * *

(c) *Future status of organizations denied exemption.* Any organization described in section 501(c)(17) or (18) or subsection (a)(1)(B) which is denied exemption under section 501(a) by reason of subsection (a) of this section, with respect to any taxable year following the taxable year in which notice of denial of exemption was received, may, under regulations prescribed by the Secretary or his delegate, file claim for exemption, and if the Secretary or his delegate, pursuant to such regulations, is satisfied that such organization will not knowingly again engage in a prohibited transaction, such organization shall be exempt with respect to taxable years after the year in which such claim is filed.

[Sec. 503(c) as amended by sec. 2(c), Act of July 14, 1960 (Pub. L. 86-667, 74 Stat. 535) [1960-2 C.B. 687]; sec. 101(j)(9) and (14), and by sec. 121(b)(6)(B) Tax Reform Act 1969 (83 Stat. 527, 542) [Pub. L. 91-172, 1969-3 C.B. 10]; sec. 2003(b)(4), Employee Retirement Income Security Act 1974 (88 Stat. 978) [Pub. L. 93-406, 1974-1 C.B.]]

§ 1.503(c)-1 Future status of organizations denied exemption.

(a) Any organization described in section 501(c)(3), (17), or (18), or an employees' trust described in section 401(a), which is denied exemption under section 501(a) by reason of the provisions of section 503(a), may file, in any taxable year following the taxable year in which notice of denial was issued, a claim for exemption. In the case of organizations described in section 501(c)(3), (17), or (18), the appropriate exemption application shall be used for this purpose, and shall be filed with the district director. In the case of an employees' trust described in section 401(a), the information described in § 1.404(a)-2 shall be submitted with a letter claiming exemption. An employees' trust described in section 401(a) shall submit this information to the district director with whom a request for a determination as to its qualification under section 401 and exemption under section 501 may be submitted under paragraph (o) of § 601.201 of this chapter (Statement of Procedural Rules). A claim for exemption must contain or have attached to it, in addition to the information generally required of such an organization claiming exemption as an organization described in section 501(c)(17), or (18), or section 401(a) (or section 501(c)(3) prior to January 1, 1970), a written declaration made under the penalties of perjury by a principal officer of such organization authorized to make such declaration that the organization will not knowingly again engage in a prohibited transaction (as defined in section 503(b) (or 4975(c) if such section applies to such organization)). In the case of section 501(c)(3) organiza-

tions which have lost their exemption after December 31, 1969, pursuant to section 503, a claim for exemption must contain or have attached to it a written agreement made under penalties of perjury by a principal officer of such organization authorized to make such agreement that the organization will not violate the provisions of chapter 42. In addition, such organization must comply with the rules for governing instruments as prescribed in § 1.508-3. See § 1.501(a)-1 for proof of exemption requirements in general.

(b) If the Commissioner is satisfied that such organization will not knowingly again engage in a prohibited transaction (as defined under section 503(b) or 4975(c), as applicable to such organization) or in the case of a section 501(c)(3) organization, will not violate the provisions of chapter 42, and the organization also satisfied all the other requirements under section 501(c)(3), (17), or (18), or section 401(a), the organization will be so notified in writing. In such case the organization will be exempt (subject to the provisions of section 501(c)(3), or sections 501(c)(17), (18), or 401(a), and 503, and 504 when applicable) with respect to the taxable years subsequent to the taxable year in which the claim described in section 503(c) is filed. Section 503 contemplates that an organization denied exemption because of the terms of such section will be subject to taxation for at least one full taxable year. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organization means the calendar year.

(c) For taxable years beginning after December 31, 1969, the denial of an exemption pursuant to this section, for a taxable year prior to January 1, 1970, of an organization described in section 501(c)(3) shall not cause such organization to cease to be described in section 501(c)(3) for purposes of part II of subchapter F, chapter 1 and for purposes of the application of chapter 42 taxes.

(d) In the case of an organization described in section 501(c)(3), which has lost its exemption pursuant to section 503, and which has not notified the Commissioner that it is applying for recognition of its exempt status under section 508(a) and this section, no gift or contribution made after December 31, 1969, which would otherwise be deductible under sections 170, 642(c), or 545(b)(2) shall be allowed as a deduction. For rules relating to the denial of deductions with respect to gifts or contributions made before January 1, 1970 see, § 1.503(e)-4.

§ 1.503(d) Statutory provisions; requirements for exemption; special rules for loans.

Sec. 503. *Requirements for exemption.* * * *

(d) *Special rule for loans.* For purposes of the application of subsection (b)(1), in the case of a loan by a trust described in section 401(a), the following rules shall apply with respect to a loan made before March 1, 1954, which would constitute a prohibited transaction if made on or after March 1, 1954:

(1) If any part of the loan is repayable prior to December 31, 1955, the renewal of such part of the loan for a period not extending beyond December 31, 1955, on the same terms, shall not be considered a prohibited transaction.

(2) If the loan is repayable on demand, the continuation of the loan without the receipt of adequate security and a reasonable rate of interest beyond December 31, 1955, shall be considered a prohibited transaction.

[Sec. 503(d) as amended by sec. 101(j)(10) and (14), Tax Reform Act 1969 (83 Stat. 527) [Pub. L. 91-172, 1969-3 C.B 10]]

§ 1.503(d)-1 Cross references.

For provisions relating to loans described in section 503(b)(1) by a trust described in section 401(a), see § 1.503(b)-1 and section 503(e) and (f) and the regulations thereunder.

§ 1.503(e) Statutory provisions; requirements for exemption; special rules.

Sec. 503. *Requirements for exemption.* * * *

(e) *Special rules.* For purposes of subsection (b)(1), a bond, debenture, note, or certificate or other evidence of indebtedness (hereinafter in this subsection referred to as "obligation") shall not be treated as a loan made without the receipt of adequate security if—

(1) Such obligation is acquired—

(A) On the market, either (i) at the price of the obligation prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or (ii) if the obligation is not traded on such a national securities exchange, at a price not less favorable to the trust than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer;

(B) From an underwriter, at a price (i) not in excess of the public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, and (ii) at which a substantial portion of the same issue is acquired by persons independent of the issuer; or

(C) Directly from the issuer, at a price not less favorable to the trust than the price paid currently for a substantial portion of the same issue by persons independent of the issuer;

(2) Immediately following acquisition of such obligation—

(A) Not more than 25 percent of the aggregate amount of obligations issued in such issue and outstanding at the time of acquisition is held by the trust, and

(B) At least 50 percent of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer; and

(3) Immediately following acquisition of the obligation, not more than 25 percent of the assets of the trust is invested in obligations of persons described in subsection (b).

[Sec. 503(e) as added by sec. 30(a), Technical Amendments Act 1958 (72 Stat. 1629) [Pub. L. 85-866, 1958-3 C.B. 254]; amended by Sec. 2(d), Act of July 14, 1960 (Pub. L. 86-667, 74 Stat 535) [1960-2 C.B. 687]; sec. 101(j)(11) and (14), Tax Reform Act 1969 (83 Stat. 527) [Pub. L. 91-172, 1969-3 C.B. 10]]

§ 1.503(e)-1 Special rules.

(a) *In general.* (1) Section 503(e) provides that for purposes of section 503(b)(1) (relating to loans made without the receipt of adequate security and a reasonable rate of interest) the acquisition of a bond, debenture, note, or certificate or other evidence

of indebtedness shall not be treated as a loan made without the receipt of adequate security if certain requirements are met. Those requirements are described in § 1.503(e)-2.

(2) Section 503(e) does not affect the requirement in section 503(b)(1) of a reasonable rate of interest. Thus, although the acquisition of a certificate of indebtedness which meets all of the requirements of section 503(e) and of § 1.503(e)-2 will not be considered as a loan made without the receipt of adequate security, the acquisition of such an indebtedness does constitute a prohibited transaction if the indebtedness does not bear a reasonable rate of interest.

(3) The provisions of section 503(e) do not limit the effect of section 401(a) and § 1.401-2, section 501(c)(17)(A)(i), or section 501(c)(18)(A), all relating to the use or diversion of corpus or income of the respective employee trusts. Furthermore, the provisions of section 503(e) do not limit the effect of any of the provisions of section 503 other than section 503(b)(1). Thus, for example, although a loan made by an employees' trust described in section 503(a)(1)(B) meets all the requirements of section 503(e) and therefore is not treated as a loan made without the receipt of adequate security, such an employees' trust making such a loan will lose its exempt status if the loan is not considered as made for the exclusive benefit of the employees or their beneficiaries. Similarly, a loan which meets the requirements of section 503(e) will constitute a prohibited transaction within the meaning of section 503(b)(6) if it results in a substantial diversion of the trust's income or corpus to a person described in section 503(b).

(b) *Definitions.* For purposes of section 503(e):

(1) The term "obligation" means bond, debenture, note, or certificate or other evidence of indebtedness.

(2) The term "issuer" includes any person described in section 503(b) who issues an obligation.

(3)(i) The term "person independent of the issuer" means a person who is not related to the issuer by blood, by marriage, or by reason of any substantial business interests. Persons who will be considered not to be independent of the issuer include but are not limited to:

(*a*) The spouse, ancestor, lineal descendant, or brother or sister (whether by whole or half blood) of an individual who is the issuer of an obligation;

(*b*) A corporation controlled directly or indirectly by an individual who is the issuer, or directly or indirectly by the spouse, ancestor, lineal descendant, or brother or sister (whether by whole or half blood) of an individual who is the issuer;

(*c*) A corporation which directly or indirectly controls, or is controlled by, a corporate issuer;

(*d*) A controlling shareholder of a corporation which is the issuer, or which controls the issuer;

(*e*) An officer, director, or other employee of the issuer, of a corporation controlled by the issuer, or of a corporation which controls the issuer;

(*f*) A fiduciary of any trust created by the issuer, by a corporation which controls the issuer, or by a corporation which is controlled by the issuer; or

(*g*) A corporation controlled by a person who controls a corporate issuer.

(ii) For purposes of subdivision (i) of this subparagraph, the term "control" means, with respect to a corporation, direct or indirect ownership of 50 percent or more of the total combined voting power of all voting stock or 50 percent or more of the total value of shares of all classes of stock. If the aggregate amount of stock in a corporation owned by an individual and by the spouse, ancestors, lineal descendants, brothers, and sisters (whether by whole or half blood) of the individual is 50 percent or more of the total combined voting power of all voting stock or is 50 percent or more of the total value of all classes of stock, then each of these persons shall be considered as the controlling shareholder of the corporation.

(iii) In determining family relationships for purposes of subdivision (i) of this subparagraph, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(4) The term "issue" means all the obligations of an issuer which are offered for sale on substantially the same terms. Obligations shall be considered offered for sale on substantially the same terms if such obligations would, at the same time and under the same circumstances, be traded on the market at the same price. On the other hand, if the terms on which obligations are offered for sale differ in such manner as would cause such obligations to be traded on the market at different prices, then such obligations are not part of the same issue. The following are examples of terms which, if different, would cause obligations to be traded on the market at different prices:

(i) Interest rate;
(ii) Maturity date;
(iii) Collateral; and
(iv) Conversion provisions.

The fact that obligations are offered for sale on different dates will not preclude such obligations from being part of the same issue if they all mature on the same date and if the terms on which they are offered for sale are otherwise the same, since such obligations would, at the same time and under the same conditions, be traded on the market at the same price. Obligations shall not be considered part of the same issue merely because they are part of the same authorization or because they are registered as part of the same issue with the Securities and Exchange Commission.

§ 1.503(e)-2 Requirements.

(a) *In general.* The requirements which must be met under section 503

(e) for an obligation not to be treated as a loan made without the receipt of adequate security for purposes of section 503(b)(1) are described in paragraphs (b), (c), and (d) of this section. For purposes of this section, the term "employee trust" shall mean any of the three kinds of organizations described in section 503(a)(1).

(b) *Methods of acquisition*—(1) *In general.* The employee trust must acquire the obligation on the market, by purchase from an underwriter, or by purchase from the issuer, in the manner described in subparagraph (2), (3), or (4) of this paragraph.

(2) *On the market.* (i) An obligation is acquired on the market when it is purchased through a national securities exchanged which is registered with the Securities and Exchange Commission, or when it is purchased in an over-the-counter transaction. For purposes of the preceding sentence, securities purchased through an exchange which is not a national securities exchange registered with the Securities and Exchange Commission shall be treated as securities purchased in an over-the-counter transaction.

(ii) (*a*) If the obligation is listed on a national securities exchange registered with the Securities and Exchange Commission, it must be purchased through such an exchange or in an over-the-counter transaction at a price not greater than the price of the obligation prevailing on such an exchange at the time of the purchase by the employee trust.

(*b*) For purposes of section 503(e), the price of the obligation prevailing at the time of the purchase means the price which accurately reflects the market value of the obligation. In the case of an obligation purchased through a national securities exchange which is registered with the Securities and Exchange Commission, the price paid for the obligation will be considered the prevailing price of the obligation. In the case of an obligation purchased in an over-the-counter transaction, the prevailing price may be the price at which the last sale of the obligation was effected on such national securities exchange immediately before the employee's trust's purchase of such obligation on the same day or may be the mean between the highest and lowest prices at which sales were effected on such exchange on the same day or on the immediately preceding day or on the last day during which there were sales of such obligation or may be a price determined by any other method which accurately reflects the market value of the obligation.

(iii) (*a*) If the obligation is not listed on a national securities exchange which is registered with the Securities and Exchange Commission, it must be purchased in an over-the-counter transaction at a price not greater than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer.

(*b*) For purposes of section 503(e) the offering price for the obligation at the time of the purchase means the price which accurately reflects the market value of the obligation. The offering price may be the price at which the last sale of the obligation to a person independent of the issuer was effected immediately before the employee trust's purchase of such obligation on the same day or may be the mean between the highest and lowest prices at which sales to persons independent of the issuer were effected on the same day or on the immediately preceding day or on the last day during which there were sales of such obligation or may be a price determined by any other method which accurately reflects the market value of the obligation. The offering price for an obligation must be a valid price for the amount of the obligations which the trust is purchasing. For example, if an employees' trust described in section 503(a)(1)(B) purchases 1,000 bonds of the employer corporation at the offering price established by current prices for a lot of 10 such bonds, such offering price may not be a valid price for 1,000 bonds and the purchase may therefore not meet the requirements of this subdivision. For a purchase of an obligation to qualify under this subdivision, there must be sufficient current prices quoted by persons independent of the issuer to establish accurately the current value of the obligation. Thus, if there are no current prices quoted by persons independent of the issuer, an over-the-counter transaction will not qualify under this subparagraph even though the obligation was purchased in an arm's length transaction from a person independent of the issuer.

(iv) For purposes of this section, an over-the-counter transaction is one not executed on a national securities exchange which is registered with the Securities and Exchange Commission. An over-the-counter transaction may be made through a dealer or an exchange which is not such a national securities exchange or may be made directly from the seller to the purchaser.

(3) *From an underwriter.* An obligation may be purchased from an underwriter if it is purchased at a price not greater than:

(i) The public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, or

(ii) The price at which a substantial portion of the issue including such obligation is acquired by persons independent of the issuer,

whichever is the lesser price. For purposes of this subparagraph, a portion of the issue will be considered substantial if the purchases of such portion by persons independent of the issuer are sufficient to establish the fair market value of the obligations included in such issue. In determining whether the purchases are sufficient to establish the fair market value, all the surrounding

facts and circumstances will be considered, including the number of independent purchasers, the aggregate amount purchased by each such independent purchaser, and the number of transactions. In the case of a large issue, purchases of a small percentage of the outstanding obligations may be considered purchases of a substantial portion of the issue; whereas, in the case of a small issue, purchases of a larger percentage of the outstanding obligations will ordinarily be required. The requirement in subdivision (ii) of this subparagraph contemplates purchase of the obligations by persons independent of the issuer contemporaneously with the purchase by the employee trust.

If a substantial portion has been purchased at different prices, the price of the portion may be based on the average of such prices, and if several substantial portions have been sold to persons independent of the issuer, the price of any of the substantial portions may be used for purposes of this subparagraph.

(4) *From the issuer.* An obligation may be purchased directly from the issuer at a price not greater than the price paid currently for a substantial portion of the same issue by persons independent of the issuer. This requirement contemplates purchase of a substantial portion of the same issue by persons independent of the issuer contemporaneously with the purchase by the employee trust. For purposes of this subparagraph, a portion of the issue will be considered substantial if the purchases of such portion by persons independent of the issuer are sufficient to establish the fair market value of the obligations included in such issue. In determining whether the purchases are sufficient to establish the fair market value, all the surrounding facts and circumstances will be considered, including the number of independent purchasers, the aggregate amount purchased by each such independent purchaser, and the number of transactions. In the case of a large issue, purchases of a small percentage of the outstanding obligations may be considered purchases of a substantial portion of the issue; whereas, in the case of a small issue, purchases of a larger percentage of the outstanding obligations will ordinarily be required. The price paid for a substantial portion of the issue may be determined in the manner provided in subparagraph (3) of this paragraph.

(c) *Limitations on holdings of obligations.* (1) Immediately following acquisition of the obligation by the employee trust:

(i) Not more than 25 percent of the aggregate amount of the obligations issued in such issue and outstanding immediately after acquisition by the trust may be held by the trust, and

(ii) At least 50 percent of such aggregate amount must be held by persons independent of the issuer.

(2)(i) For purposes of subparagraph (1) of this paragraph, an obligation is not considered as outstanding if it is held by the issuer. For example, if an obligation which has been issued and outstanding is repurchased and held by the issuer, without cancellation or retirement, such an obligation is not considered outstanding.

(ii) For purposes of subparagraph (1) of this paragraph, the amounts of the obligations held by the trust and by persons independent of the issuer shall be computed on the basis of the face amount of the obligations.

(d) *Limitation on amount invested in obligations.* (1)(i) Immediately following acquisition of the obligation, not more than 25 percent of the assets of the employee trust may be invested in all obligations of all persons described in section 503(b). For purposes of determining the amount of the trust's assets which are invested in obligations of persons described in section 503(b) immediately following acquisition of the obligation, those obligations shall be valued as follows:

(*a*) Those obligations included in the acquisition in respect of which the percentage test in the first sentence of this subdivision is being applied shall be valued at their adjusted basis, as provided in section 1011, relating to adjusted basis for determining gain or loss; and

(*b*) All other obligations of persons described in section 503(b) which were part of the trust's assets immediately before the acquisition of the obligations described in (*a*) of this subdivision shall be valued at their fair market value on the day that the obligations described in (*a*) of this subdivision were acquired. For purposes of determining the total amount of the assets of the trust (including obligations of persons described in section 503(b)), there shall be used the fair market value of those assets on the day the obligation is acquired.

(ii) The application of the rules in subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On February 1, 1960, an exempt employees' trust described in section 401 (a) purchases unsecured debentures issued by the employer corporation for $1,000. At the time of this purchase, such debentures have a fair market value of $1,200. Immediately after the purchase of such unsecured debentures, the assets of the trust consist of the following:

	Cost	Fair market value on Feb. 1, 1960
(a) Assets other than obligations of persons described in section 503(b)	$5,000	$7,800
(b) Obligations of persons described in section 503(b) acquired before Feb. 1, 1960	500	1,000
(c) Unsecured debentures of employer purchased on Feb. 1, 1960	1,000	1,200

Immediately following acquisition of the unsecured debentures by the trust, the percent of the assets of the trust that are invested in all obligations of all persons described in section 503 (b) is computed as follows:

(1) Obligations of persons described in section 503(b)

	Cost	Fair market value on Feb. 1, 1960
acquired before Feb. 1, 1960 (valued at fair market value)		$1,000
(2) Unsecured debentures of employer purchased on Feb. 1, 1960 (valued at cost) --		$1,000
(3) Total amount of trust's assets invested in obligations of persons described in section 503(b) ((1) plus (2))		$2,000
(4) Assets of the trust other than obligations of persons described in section 503(b) (valued at fair market value on Feb. 1, 1960)		$7,800
(5) Obligations of persons described in section 503(b) acquired before Feb. 1, 1960 (valued at fair market value on Feb. 1, 1960)		$1,000
(6) Unsecured debentures of employer purchased on Feb. 1, 1960 (valued at fair market value on Feb. 1, 1960) --		$1,200
(7) Total assets of the trust valued at fair market value on Feb. 1, 1960 (sum of (4), (5), and (6))		$10,000
(8) Percent of assets of the trust invested in all obligations of all persons described in section 503(b) immediately following purchase of unsecured debentures on Feb. 1, 1960 ((3) ÷ (7), that is, $2,000 ÷ $10,000)		20%

(2) In determining for purposes of subparagraph (1) of this paragraph the amount invested in obligations of persons described in section 503(b), there shall be included amounts invested in any obligations issued by any such person, irrespective of whether the obligation is secured, and irrespective of whether the obligation meets the conditions of section 503(e) or section 503(f). Obligations of persons described in section 503(b) other than the issuer of the obligation to which section 503(e) applies are also included within the 25 percent limitation. For example, if on February 19, 1959, an exempt employees' trust described in section 401(a) purchases unsecured debentures issued by the employer corporation in a transaction effected on the New York Stock Exchange, and if immediately after the purchase 10 percent of the trust's assets is invested in such debentures and 20 percent of its assets is invested in a loan made with adequate security on January 12, 1959, to the wholly-owned subsidiary of the employer corporation, then the purchase of the employer's debentures will not qualify under section 503(e) since 30 percent of the trust's assets are then invested in obligations of persons described in section 503(b).

(e) *Change of terms of an obligation.* A change in terms of an obligation is considered as the acquisition of a new obligation. If such new obligation is not adequately secured, the requirements of section 503(e) must be met at the time the terms of the obligation are changed for such section to be applicable to such new loan.

§ 1.503(e)-3 Effective dates.

(a) Section 503(e) and §§ 1.503(e)-1 and 1.503(e)-3 are effective in the case of an employees' trust described in section 401(a) for taxable years ending after March 15, 1956. Thus, if during a taxable year ending before March 16, 1956, an employees' trust made a loan which meets the requirements of section 503(e), such loan will not be treated as made without the receipt of adequate security and will not cause the loss of exemption for taxable years ending after March 15, 1956, although such loan was not considered adequately secured when made. (However, section 503 does not apply to organizations described in section 401(a) not referred to in section 4975(g)(2) or (3) for transactions occurring after December 31, 1974.)

(b)(1) In the case of obligations acquired by an employees' trust described in section 401(a) before September 2, 1958, which were held on that date, the requirements described in paragraphs (c) and (d) of § 1.503(e)-2 which were not satisfied immediately following the acquisition shall be treated as satisfied at that time if those requirements would have been satisfied had the obligations been acquired on September 2, 1958. For example, on January 3, 1955, an employees' trust described in section 401(a) purchased through the New York Stock Exchange unsecured debentures issued by the employer corporation. Under section 503(e) the acquisition of such debentures by the trust will not be treated for taxable years ending after March 15, 1956, as a loan made without the receipt of adequate security if the debentures were held by the employees' trust on September 2, 1958, and if the requirements of paragraphs (c) and (d) of § 1.503(e)-2 which were not met on January 3, 1955, were met on September 2, 1958, as if that date were the date of acquisition.

(2) In the case of obligations acquired before September 2, 1958, which were not held by the employees' trust described in section 401(a) on that date, only the requirements described in paragraph (b) of § 1.503(e)-2 must be satisfied for section 503(e) to be applicable to such acquisition. For example, if on December 5, 1956, an employees' trust lent money to the employer corporation by purchasing a debenture issued by the employer and if the trust sold the debenture on August 1, 1958, such loan would not be treated as made without the receipt of adequate security if the requirement described in paragraph (b) of § 1.503(e)-2 was met on December 5, 1956.

(c) Section 503(e) and §§ 1.503(e)-1 and 1.503(e)-2 are effective in the case of trusts described in section 501(c)(17) with respect to loans made, renewed, or, in the case of demand loans, continued after December 31, 1959, and in the case of trusts described in section 501(c)(18) with respect to loans made, renewed or, in the case of demand loans, continued after December 31, 1969.

(d) See paragraph (b)(2) of § 1.503(b)-1 for effective dates for the

application of the definition of adequate security.

§ 1.503(e)-4 Disallowance of charitable deductions for certain gifts made before January 1, 1970.

Paragraphs (a), (b), and (c) of this section shall apply only to gifts or contributions made before January 1, 1970, to an organization described in section 501(c)(3). For rules relating to the denial of deductions with respect to gifts or contributions made after December 31, 1969, see § 1.503(c)-1(d).

(a) No gift or contribution which would otherwise be allowable as a charitable or other deduction under section 170, 642(c), or 545(b)(2) shall be allowed as a deduction if made to an organization described in section 501(c)(3) which at the time the gift or contribution is made is not exempt under section 501(a) by reason of the provisions of section 503.

(b) If an organization which is described in section 501(c)(3) is not exempt because it engaged in a prohibited transaction involving a substantial part of its income or corpus with the purpose of diverting its income or corpus from its exempt purposes, and if the organization receives a gift or contribution during, or prior to, its taxable year in which such prohibited transaction occurred, then a deduction by the donor with respect to the gift or contribution shall not be disallowed under section 503(b) unless the donor (or any member of his family if the donor is an individual) is a party to such prohibited transaction. For the purpose of the preceding sentence, "family" is defined in section 267(c)(4) and includes brothers and sisters, whether by whole or half blood, spouse, ancestors, and lineal descendants. See the regulations under section 267(c).

(c) The application of § 1.503(e)-4 may be illustrated by the following example:

Example. In 1954, Corporation M, which files its income tax returns on the calendar year basis, creates a foundation purportedly for charitable purposes and deducts from its gross income for that year the amount of the gift to the foundation. Corporation M makes additional gifts to this foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. B, an individual, also contributes to the foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. In 1955, the foundation commences purposely to divert its corpus to the benefit of Corporation M, and a substantial amount of each corpus is so diverted by the close of the taxable year 1956. For 1955 and subsequent taxable years, the exemption allowed the foundation as an organization described in section 501(c)(3) is denied by reason of the provisions of section 503(a). Both Corporation M and individual B would be disallowed any deduction for the contributions made during 1957 to the foundation. Moreover, the charitable deductions taken by Corporation M for contributions to the foundation in the years 1955 and 1956 would also be disallowed since Corporation M was a party to the prohibited transaction. If the facts and surrounding circumstances indicate that the contribution in 1954 by Corporation M was for the purpose of the prohibited transaction, then the charitable deduction for the year 1954 shall also be disallowed with respect to Corporation M, since the prohibited transaction would then have commenced with the making of such contribution and the exemption allowed the foundation would then be denied for 1954 by reason of the provisions of § 1.503(e)-4. B's deductions for his contributions for the years 1955 and 1956 will not be disallowed since he was not a party to the prohibited transaction.

§ 1.503(f) Statutory provisions; requirements for exemption; loans with respect to which employers are prohibited from pledging assets.

Sec. 503. *Requirements for exemption.*
* * *

(f) *Loans with respect to which employers are prohibited from pledging certain assets.* Subsection (b)(1) shall not apply to a loan made by a trust described in section 401(a) to the employer (or to a renewal of such a loan or, if the loan is repayable upon demand, to a continuation of such a loan) if the loan bears a reasonable rate of interest, and if (in the case of a making or renewal)—

(1) the employer is prohibited (at the time of such making or renewal by any law of the United States or regulation thereunder from directly or indirectly pledging, as security for such a loan, a particular class or classes of his assets the value of which (at such time) represents more than one-half of the value of all his assets;

(2) the making or renewal, as the case may be, is approved in writing as an investment which is consistent with the exempt purposes of the trust by a trustee who is independent of the employer, and no other such trustee had previously refused to give such written approval; and

(3) immediately following the making or renewal, as the case may be, the aggregate amount loaned by the trust to the employer, without the receipt of adequate security, does not exceed 25 percent of the value of all the assets of the trust. For purposes of paragraph (2), the term "trustee" means, with respect to any trust for which there is more than one trustee who is independent of the employer, a majority of such independent trustees. For purposes of paragraph (3), the determination as to whether any amount loaned by the trust to the employer is loaned without the receipt of adequate security shall be made without regard to subsection (e).

[Sec. 503(f) as added by sec. 30(b), Technical Amendments Act 1958 (72 Stat. 1630) [Pub. L. 85-866, 1958-3 C.B. 254]; amended by sec. 101(j)(12) and (14), Tax Reform Act 1969 (83 Stat. 527) [Pub. L. 91-172, 1969-3 C.B. 10]]

§ 1.503(f)-1 Loans by employers who are prohibited from pledging assets.

(a) *In general.* (1) Section 503(f) provides that section 503(b)(1) shall not apply to a loan made to the employer by an employees' trust described in section 401(a) if the loan bears a reasonable rate of interest and certain conditions are met. Section 503(f) also applies to the renewal of loans to the employer and, in the case of demand loans, to the continuation of such loans.

(2) The provisions of section 503(f) do not limit the effect of section 401(a) and § 1.401-2, relating to use or diversion of corpus or income of an employees' trust, or the effect of any of the provisions of section 503 other than section 503(b)(1). Consequently, although a loan made by an employees' trust described in section 503(a)(1)(B) meets all the requirements of section 503(f) and therefore is not treated as a loan made without the receipt of adequate security, an employees' trust making such a loan will lose its exempt status if the loan is not consid-

ered as made for the exclusive benefit of the employees or their beneficiaries. Similarly, a loan which meets the requirements of section 503(f) will constitute a prohibited transaction within the meaning of section 503(b)(6) if it results in a substantial diversion of the trust's income or corpus to a person described in section 503(b).

(b) *Conditions.* (1) Section 503(f) applies to a loan only if, with respect to the making or renewal of the loan, the conditions described in subparagraphs (2), (3), and (4) of this paragraph are met. For purposes of this paragraph, the mere continuance of a demand loan is not considered as the making or renewal of such a loan.

(2) The employer must be prohibited (at the time of the making or renewal of the loan) by any law of the United States or regulations thereunder from directly or indirectly pledging, as security for such a loan, a particular class or classes of his assets the value of which (at such time) represents more than one-half of the value of all his assets. If a loan is made or renewed when the employer is prohibited by a law of the United States (or the regulations thereunder) from pledging a class of his assets, the qualification of such a loan under section 503(f) will not be affected by a subsequent change in such law or regulations permitting the employer to pledge such assets, unless such loan is renewed after such change. See section 8(a) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78h (a)), which prohibits certain persons from pledging a class of assets as security for loans, and 12 CFR 220.5 (a) (credit by brokers, dealers, and members of national securities exchanges).

(3) The making or renewal, as the case may be, must be approved in writing as an investment which is consistent with the exempt purposes of the trust by a trustee who is independent of the employer, and such written approval must not have been previously refused by any other such trustee. A trustee is independent of the employer, for purposes of this subparagraph, if he is entirely free of influence or control by the employer. For example, if the employer is a partnership, then a partner in such partnership, or a member of a partner's family would not be considered independent of the employer. Similarly, an employee of the employer would not be considered independent of the employer. For purposes of this subparagraph, the term "trustee" means, with respect to any trust for which there are two trustees who are independent of the employer, both of such trustees and, with respect to any trust for which there are more than two such independent trustees, a majority of the trustees independent of the employer.

(4)(i) Immediately following the making or renewal, as the case may be, the aggregate amount lent by the trust to the employer, without the receipt of adequate security, must not exceed 25 percent of the value of all the assets of the trust.

(ii) For purposes of subdivision (i) of this subparagraph, the determination as to whether any amount lent by the trust to the employer is a loan made without the receipt of adequate security shall be made without regard to section 503(e). Thus, if an employees' trust makes a loan on January 2, 1959, to the employer without adequate security (but which loan is not considered as made without adequate security under section 503(e)), and if immediately after making such loan 10 percent of the value of all its assets is invested in such loan, then the trust may on that day invest not more than an additional 15 percent of its assets in a loan which would be considered made without adequate security if it were not for the provisions of section 503(f).

(iii) For purposes of subdivision (i) of this subparagraph, in determining the value of all the assets of the trust, there shall be used the fair market value of those assets on the day of the making or renewal.

(c) *Reasonable rate of interest.* Section 503(f) only applies if, in addition to meeting the conditions described in paragraph (b) of this section, the loan bears a reasonable rate of interest when it is made, renewed, or, in the case of demand loans, during the period of its existence.

(d) *Change of terms of loan.* A change in the terms of a loan (including a reduction in the security for a loan) is considered as the making of a new loan. If such a new loan is not adequately secured, the requirements of section 503(f) must be met at the time the terms of the loan are changed for such section to be applicable to such new loan.

(e) *Effective date.* (1) This section and section 503(f) are effective for taxable years ending after September 2, 1958, but only with respect to periods after such date. Thus, if a loan was made on or before September 2, 1958, without the receipt of adequate security and if, when such loan was made, it met all of the requirements of section 503(f) and this section, then the loan is not subject to section 503(b)(1) after September 2, 1958, and would not constitute a prohibited transaction after that date because of a lack of adequate security.

(2) See paragraph (b)(2) of § 1.503(b)-1 for the effective dates for application of the definition of adequate security.

Par. 11. Section 1.504 is repealed.

Par. 12. Paragraph (e) of § 1.504-1 is amended and paragraphs (g) and (h) are added to § 1.504-1. The amended and added provisions read as follows:

§ 1.504-1 Denial of exemption.

* * * * *

(e) An organization that has lost its exemption by reason of the provisions of section 504 may, in order to reestablish its exemption, file a claim for exemption with the district director.

Form 1023, the exemption application, shall be used for this purpose in accordance with the provisions of § 1.501(a)-1.

* * * * *

(g) In the case of an organization described in section 501(c)(3) denied exemption under section 501(a) solely by reason of the provisions of section 504, such organization will not cease to be described in section 501(c)(3) for purposes of Part II of subchapter F, chapter 1 and for purposes of the application of chapter 42 taxes.

(h) Section 504 shall result in a loss of exemption to any organization only as a result of a transaction occuring prior to January 1, 1970.

Par. 13. Section 1.663(a) is amended by revising section 663(a)(2) and by adding a historical note. The amended and added provisions read as follows:

§ 1.663(a) Statutory provisions; estates and complex trusts; special rules applicable to sections 661 and 662; exclusions.

Sec. 663. *Special rules applicable to section 661 and 662.* (a) *Exclusions.* * * *

(2) *Charitable, etc. distributions.* Any amount paid or permanently set aside or otherwise qualifying for the deduction provided in section 642(c) (computed without regard to sections 508(d), 681, and 4948(c)(4)).

[Sec. 663 as amended by sec. 101(j)(17), Tax Reform Act 1969 (83 Stat. 528) [Pub. L. 91-172, 1969-3 C.B. 10]]

Par. 14. The last sentence of § 1.663(a)-2 is amended to read as follows:

§ 1.663(a)-2 Charitable, etc., distributions.

* * * For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income and private foundations).

Par. 15. Section 1.681(a) is amended to read as follows:

§ 1.681(a) Statutory provisions; limitation on charitable deduction.

Sec. 681. *Limitation on charitable deduction*—(a) *Trade or business income.* In computing the deduction allowable under section 642(c) to a trust, no amount otherwise allowable under section 642(c) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its unrelated business income for such year. For purposes of the preceding sentence, the term "unrelated business income" means an amount equal to the amount which, if such trust were exempt from tax under section 501(a), by reason of section 501(c)(3), would be computed as its unrelated business taxable income under section 512 (relating to income derived from certain business activities and from certain property acquired with borrowed funds).

[Sec. 681(a) as amended by sec. 121(d)(2), Tax Reform Act 1969 (83 Stat. 547) [Pub. L. 91-172, 1969-3 C.B. 10]]

Par. 16. The first sentence of § 1.681(a)-1 is amended to read as follows:

§ 1.681(a)-1 Limitation on charitable contributions deductions of trusts; scope of section 681.

Under section 681, the unlimited charitable contributions deduction otherwise allowable to a trust under section 642(c) is, in general, subject to percentage limitations, corresponding to those applicable to contributions by an individual under section 170(b)(1)(A) and (B), under the following circumstances;

(a) To the extent that the deduction is allocable to "unrelated business income";

(b) For taxable years beginning before January 1, 1970, if the trust has engaged in a prohibited transaction;

(c) For taxable years beginning before January 1, 1970, if income is accumulated for a charitable purpose and the accumulation is (1) unreasonable, (2) substantially diverted to a noncharitable purpose, or (3) invested against the interests of the charitable beneficiaries.

* * * * *

Par. 17. Sections 1.681(b) through § 1.681(d)-1 are deleted and the following is inserted in lieu thereof:

§ 1.681(b) Statutory provisions; cross reference.

Sec. 681 *Limitation on charitable deduction.* * * *

(b) *Cross reference.* For disallowance of certain charitable, etc., deductions otherwise allowable under section 642(c), see sections 508(d) and 4948(c)(4).

[Sec. 681(b) as amended by sec. 101(j)(19), Tax Reform Act 1969 (83 Stat. 528) [Pub. L. 91-172, 1969-3 C.B. 10]]

§ 1.681(b)-1 Cross reference.

For disallowance of certain charitable, etc., deductions otherwise allowable under section 642(c), see sections 508(d) and 4948(c)(4). See also 26 CFR §§ 1.681(b)-1 and 1.681(c)-1 (rev. as of Apr. 1, 1974) for provisions applying before January 1, 1970.

Par. 18. Section 20.2039 is amended by revising section 2039(c)(3) and by revising the historical note. The amended provisions read as follows:

§ 20.2039 Statutory provision; annuities.

Sec. 2039. *Annuities.* * * *

(c) *Exemption of annuities under certain trusts and plans.* * * *

(3) A retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 170(b)(1)(A)(ii) or (vi), or which is a religious organization (other than a trust), and which is exempt from tax under section 501(a); or

* * * * *

[Sec. 2039 as amended by sec. 23(e), 67(a), Technical Amendments Act 1958 (72 Stat. 1622, 1658) [Pub. L. 85-866, 1958-3, C.B. 254]; sec. 7(i), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 830) [Pub. L. 87-792, 1962-3 C.B. 89]; sec. 2(a) Act of Mar. 8, 1966 (Pub. L. 89-365, 80 Stat. 33) [1966-1 C.B. 377]; sec. 101(j)(23), Tax Reform Act 1969 (83 Stat. 528) [Pub. L. 91-172, 1969-3 C.B. 10]]

Par. 19. Paragraph (b)(3) and example (5) of paragraph (b)(4) of § 20.2039-2 are amended to read as follows:

§ 20.2039-2 Annuities under "qualified plans" and section 403(b) annuity contracts.

* * * * *

(b) *Plans and annuity contracts to which section 2039(c) applies.* * * *

(3) In the case of a decedent dying after December 31, 1957, a retirement annuity contract purchased for an employee by an employer which, for its taxable year in which the purchase occurred, is an organization referred to in section 170(b)(1)(A)(ii) or (vi) or which is a religious organization (other than a trust) and is exempt from tax under 501(a); or

(4) * * *

Example (5). An employer purchased a retirement annuity contract for an employee which was to provide the employee, upon his retirement at age 60, with an annuity for life and which was to provide his wife, upon the employee's death after retirement, with a similar annuity for life. The employer, for its taxable year in which the annuity contract was purchased, was an organization referred to in section 170(b)(1)(A)(ii), and was exempt from tax under section 501(a). The entire amount of the purchase price of the annuity contract was excluded from the employee's gross income under section 403(b). No part of the value of the survivor annuity payable after the employee's death is includible in the decedent's gross estate by reason of the provisions of section 2039(c).

Par. 20. Section 20.2106 is amended by revising section 2106(a)(2)(A)(ii) and (iii), (a)(2)(E), and (a)(3) and the historical note to read as follows:

§ 20.2106 Statutory provisions; taxable estate.

Sec. 2106. *Taxable estate*—(a) *Definition of taxable estate.* * * *

* * * * *

(2) *Transfers for public, charitable, and religious uses*—(A) *In general.* * * *

(ii) To or for the use of any domestic corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office; or

(iii) To a trustee or trustees, or a fraternal society, order, or association operating under the lodge system, but only if such contributions or gifts are to be used within the United States by such trustee or trustees, or by such fraternal society, order, or association, exclusively for religious charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no substantial part of the activities of such trustee or trustees, or of such fraternal society, order, or association, is carrying on propaganda, or otherwise attempting to influence legislation, and such trustee or trustees, or such fraternal society, order, or association, does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

* * * * *

(E) *Disallowance of deductions in certain cases.* The provisions of section 2055(c) shall be applied in the determination of the amount allowable as a deduction under this paragraph.

* * * * *

(3) *Exemption.*—

(A) *General rule.* An exemption of $30,000.

(B) *Residents of possessions of the United States.* In the case of a decedent who is considered to be a "nonresident not a citizen of the United States" under the provisions of section 2209, the exemption shall be the greater of (i) $30,000, or (ii) that proportion of the exemption authorized by section 2052 which the value of that part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated.

[Sec. 2106 as amended by sec. 30(d), Technical Amendments Act 1958 (72 Stat. 1631) [Pub. L. 85-866, 1958-3 C.B. 254]; sec. 4(c), Act of Sept. 14, 1960 (Pub. L. 86-779, 74 Stat. 1000 [1960-2 C.B. 709]; sec. 108(e), Foreign Investors Tax Act 1966 (80 Stat. 1572) [Pub. L. 89-809, 1966-2 C.B. 656]; secs. 201(d)(2)(B) and (4), Tax Reform Act 1969 (83 Stat. 561) [Pub. L. 91-172, 1969-3 C.B. 10]]

Par. 21. Section 25.2517 is amended by revising section 2517(a)(3) and by revising the historical note. The amended provisions read as follows:

§ 25.2517 Statutory provision; certain annuities under qualified plans.

Sec. 2517. *Certain annuities under qualified plans.* (a) *In general.* * * *

(3) A retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 170(b)(1)(A)(ii) or (vi), or which is a religious organization (other than a trust), and which is exempt from tax under section 501(a); or

* * * * *

[Sec. 2517 as added by sec. 68 and as amended by sec. 23(f), Technical Amendments Act 1958 (72 Stat. 1659) [Pub. L. 85-866 1958-3 C.B. 254]; sec. 7(j), Self-Employed Individuals Tax Retirement Act 1962 (76 Stat. 830) [Pub. L. 87-792 1962-3 C.B. 89]; sec. 2(b), Act of Mar. 8, 1966 (Pub. L. 89-365, 80 Stat. 33) [1961-1 C.B. 377]; sec. 101(j)(24), Tax Reform Act 1969 (83 Stat. 528) [Pub. L. 91-172, 1969-3 C.B. 10]]

Par. 22. Paragraph (b)(1)(iii) and Example (3) of paragraph (c)(1) of § 25.2517-1 are amended to read as follows:

§ 25.2517-1 Employees' annuities.

* * * * *

(b) *Annuities or other payments to which section 2517 applies.* * * *

(1) * * *

(iii) A retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 170(b)(1)(A)(ii) or (vi) or which is a religious organization (other than a trust) and is exempt from tax under section 501(a); or

* * * * *

(c) *Amount excludible from gift.* (1) * * *

Example (3). An employer purchased a retirement annuity contract for an employee which was to provide the employee, upon his retirement at age 60, with an annuity for life and which contained a provision for designating a surviving beneficiary. Assume that the employee made an irrevocable election whereby he would receive a lesser annuity, and after his death, annuity payments would be continued to his wife. At the time of making the election (January 20, 1971), the employer was an organization referred to in section 170(b)(1)(A)(vi) and exempt from tax under section 501(a). As of the date of election the total contributions toward the cost of the annuity, all by the employer, amounted to $25,000. Of this amount $5,000 was includible in the employee's income under the requirements of section 403(b) and is, therefore, considered as the employee's contributions for the purpose of applying section 2517(b).

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved Aug. 10, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

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Part II.—Private Foundations

Section 507.—Termination of Private Foundation Status

26 CFR 1.507-2: Special rules; transfer to, or operation as, public charity.

Definition of a community trust and the termination of private foundation status by transfer of an organization's net assets to a public charity. See T.D. 7440, page 60.

Section 509.—Private Foundation Defined

26 CFR 1.509(a)-1: Definition of private foundation.

Procedures for issuing rulings and determination letters on private foundation status under section 509(a) of the Code. See Rev. Proc. 76-33, page 655.

26 CFR 1.509(a)-1: Definition of private foundation.

Procedures for issuing determination and ruling letters on private foundation status under section 509(a) of the Code. See Rev. Proc. 76-34, page 656.

26 CFR 1.509(a)-1: Definition of private foundation.

Whether an organization that conducts a student internship program is classified as other than a private foundation under section 509(a)(1) of the Code. See Rev. Rul. 76-417, page 58.

26 CFR 1.509(a)-2: Exclusion for certain organizations described in section 170(b)(1)(A).

Whether a tutoring service is an organization described in section 170(b)(1)(A)(ii) of the Code for purposes of not being considered a private foundation. See Rev. Rul. 76-384, page 57.

26 CFR 1.509(a)-3: Broadly, publicly supported organizations.

Whether a gift of undeveloped land constitutes an unusual grant. See Rev. Rul. 76-440, page 58.

26 CFR 1.509(a)-4: Supporting organizations.

Private foundation; charitable trust granting scholarships. An exempt charitable trust whose sole purpose is to grant scholarships to students graduating from both public and private high schools in a city and whose trustees are officers of, or are elected by the membership of, a local civic league exempt under section 501(c)(4) of the Code is a supporting organization within the meaning of section 509(a)(3) and thus not a private foundation.

Rev. Rul. 76-401

Advice has been requested whether the charitable trust described below is a supporting organization within the meaning of section 509(a)(3) of the Internal Revenue Code of 1954 and thus not a private foundation.

The trust is organized and operated exclusively for charitable purposes and is exempt from Federal income tax under section 501(c)(3) of the Code. Its purpose as set forth in its articles is to grant college scholarships to students graduating from the high schools, both public and private, in a particular city. Five of the seven trustees are elected by the membership of a local civic league. The president and treasurer of the league automatically serve as the other two trustees. None of the trustees are disqualified persons with respect to the trust (within the meaning of section 4946) except in their capacity as trustees.

The league was created to render civic service for the promotion of the welfare of the citizens of the city and is exempt from Federal income tax under section 501(c)(4). If the league were an organization described in section 501(c)(3), it would be excluded from the definition of a private foundation by virtue of section 509(a)(2) because of the sources of its financial support.

Section 509(a) of the Code provides that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) other than those referred to in section 509(a)(1) through (4).

Section 509(a)(3) of the Code describes a supporting organization as one which—

(A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or (2),

(B) is operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2), and

(C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

Section 509(a) of the Code provides that, for purposes of section 509(a)(3), an organization described in section 509(a)(2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in section 509(a)(2), if it were an organization described in section 501(c)(3).

Section 1.509(a)-4(c)(1) of the regulations provides that an organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) of the Code if its articles of organization:

(i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);

(ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;

(iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and

(iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified pub-

licly supported organizations referred to in subdivision (iii) of this subparagraph.

Section 1.509(a)-4(c)(2) of the regulations indicates that in satisfying the "organizational test," the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes set forth in section 509(a)(3)(A) of the Code. An organization which is "operated, supervised, or controlled by" or "supervised or controlled in connection with" one or more section 509(a)(1) or (2) organizations to carry out the purposes of such organizations, will be considered as satisfying the "organizational test" if the purposes set forth in in its articles are similar to, but no broader than, the purposes set forth in the articles of its controlling section 509(a)(1) or (2) organizations. If, however, the organization by which it is operated, supervised, or controlled is a publicly supported section 501(c)(4), (5), or (6) organization, the supporting organization will be considered as meeting the organizational test if its articles require it to carry on activities which are exclusively religious, charitable, scientific, literary, educational, or for the prevention of cruelty to children or animals within the meaning of section 170(c)(2).

Section 1.509(a)-4(d)(2)(i) of the regulations provides that the articles of a supporting organization must designate each of the specified organizations by name, unless the supporting organization is "operated, supervised, or controlled by" or "supervised or controlled in connection with" such organizations, and the articles of organization of the supporting organization require that it be operated to support or benefit one or more beneficiary organizations which are designated by class or purpose.

Section 1.509(a)-4(e)(1) of the regulations provides that a supporting organization will be regarded as "operated exclusively" to support one or more specified publicly supported organizations only if it engages solely in activities which support or benefit the specified publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organizations.

Section 1.509(a)-4(g)(1) of the regulations provides that a supporting organization is "operated, supervised, or controlled by" one or more publicly supported organizations if a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, its members, officers, or the membership of the publicly supported organizations, even though the supporting organization's governing body is not comprised of representatives of the publicly supported organizations for whose benefit it is operated.

Section 1.509(a)-4(j)(1) of the regulations provides that under section 509(a)(3)(C) of the Code a supporting organization may not be controlled directly or indirectly by one or more disqualified persons other than foundation managers and other than one or more publicly supported organizations.

The civic league, by reason of its sources of support, is deemed to be a publicly supported organization described in section 509(a)(2) of the Code. The league elects five of the seven trustees of the trust and two officers of the league automatically serve as the other two trustees. Thus, the league controls the trust.

The trust, by its terms, is required to carry on activities which are exclusively charitable within the meaning of sections 170(c)(2) and 501(c)(3) of the Code and its charitable activity is the granting of scholarships. See Rev. Rul. 69-257, 1969-1 C.B. 151.

In a technical sense, such an organization cannot be one which "is organized, and . . . operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of" the section 501(c)(4), (5), or (6) orgnaization it is deemed to support. The "supporting" organization is a legal charity and, therefore, cannot be organized and operated to further the general purposes of a noncharitable organization. Thus, the general requirements of sections 1.509(a)-4(c), (d), and (e) of the regulations are inapplicable to organizations supporting section 501(c)(4), (5), and (6) organizations. This is specifically recognized in section 1.509(a)-4(c) in its reference to section 509(a)(3)(A) of the Code wherein it provides that if a supporting organization is operated, supervised, or controlled by a publicly supported section 501(c)(4), (5), or (6) organization, the supporting organization will be considered as satisfying the "organizational test" of section 509(a)(3)(A) "if its article require it to carry on charitable, etc. activities within the meaning of section 170(b)(2)." Although this rule is not specifically restated in section 1.509(a)-4(e) of the regulations pertaining to the "operational test" of section 509(a)(3)(A), it is equally applicable in determining whether a supporting organization satisfies that test.

Thus, since the trust is organized and operated exclusively for charitable purposes and is controlled by the civic league, it is deemed to satisfy the requirements of section 509(a)(3)(A) of the Code.

The trust is "operated, supervised, or controlled by" a publicly supported organization within the meaning of section 1.509(a)-4(g) of the regulations and thus satisfies the requirements of section 509(a)(3)(B) of the Code.

Finally, the trust is not controlled directly or indirectly by a disqualified person (as defined in section 4946 of the Code) other than its trustees in their capacity as trustees, and other

than an organization described in section 509(a)(2) and thus, the trust meets the requirements of section 509 (a)(3)(C).

Accordingly, the trust is a supporting organization within the meaning of section 509(a)(3) of the Code and thus not a private foundation.

Part III.—Taxation of Business Income of Certain Exempt Organizations

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Section 511.—Imposition of Tax on Unrelated Business Income of Charitable, etc., Organizations

26 CFR 1.511-2: Organizations subject to tax.

Whether amounts received by a religious organization from several forest owners for whom it has contracted to perform services are subject to the tax on unrelated business income. See Rev. Rul. 76-341, page 307.

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26 CFR 1.511-2: Organizations subject to tax.

Income derived by an exempt organization from mineral productions acquired with borrowed funds. See Rev. Rul. 76-354, page 179.

Section 512.—Unrelated Business Taxable Income

26 CFR 1.512(a)-1: Definition.

Rev. Rul. 76-337

Advice has been requested whether a social club exempt from Federal income tax under section 501(c)(7) of the Internal Revenue Code of 1954 must include interest received on obligations issued by a State in gross income for the purpose of computing unrelated business taxable income under section 512(a)(3).

Section 103(a) of the Code provides, in part, that gross income does not include interest on obligations of a State.

Held, interest on obligations of a State received by a social club exempt under section 501(c)(7) of the Code is not included in gross income for the purpose of computing unrelated business taxable income under section 512(a)(3).

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26 CFR 1.512(a)-1: Definition.

Unrelated income; summer tennis camp conducted on school campus. An exempt school annually contracts with an individual who conducts a 10-week summer tennis camp with the school furnishing the tennis courts, housing, and dining facilities and the individual hiring the instructors, recruiting campers, and providing supervision. The amounts received are from dual use of facilities and personnel; therefore, an allocable portion of expenses attributable to such facilities and personnel may be deducted in computing unrelated business taxable income under section 512 of the Code.

Rev. Rul. 76-402

Advice has been requested whether, under the circumstances described below, the unrelated business income of a school that is exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 derives from dual use of facilities and personnel within the meaning of section 1.512(a)-1(c) of the Income Tax Regulations or from exploitation of exempt activities within the meaning of section 1.512(a-)1(d). The question is relevant in determining the method of computing unrelated business taxable income under section 512 of the Code.

The school regularly carries on "unrelated trade or business" as that term is defined in section 513 of the Code by annually contracting with an individual who conducts a ten-week summer tennis camp. For a fee, the school provides tennis courts, furnished dormitory rooms, linens, maid service, meals, and dining facilities for use by the individual in conducting the camp. These same facilities and personnel are employed during the regular academic year in the school's educational program. Under the contract, the individual is responsible for hiring tennis instructors, recruiting campers, conducting the tennis camp program, and supervising the conduct of the instructors and tennis patrons. Although the summer tennis camp is not part of the school's curriculum, the school's name is mentioned in the promotional advertising for the camp.

The term "unrelated business taxable income" is defined in section 512 of the Code as the gross income, with certain modifications, derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions which are directly connected with the carrying on of such trade or business.

Section 1.512(a)-1(c) of the regulations provides that where facilities or personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, the expenses, depreciation, and similar items attributable to such facilities or personnel are allocated between the two uses on a reasonable basis. The portion allocable to the unrelated trade or business activity may be deducted in computing unrelated business taxable income.

Section 1.512(a)-1(d)(1) of the regulations provides, subject to an exception set forth in section 1.512 (a)-1(d)(2), that, where gross income is derived from unrelated trade or business activity which exploits an exempt activity, the expenses, depreciation, and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income.

Section 1.513-1(d)(4)(iii) of the regulations is applicable to situations in which an asset or facility used in the conduct of an exempt function is also used in a commercial endeavor. Gross income from the commercial endeavor is classified as gross income from the conduct of unrelated trade or business where such income is pro-

duced from an activity that does not contribute importantly to the accomplishment of an exempt purpose. To illustrate, the regulation provides an example of a museum that, during regular museum hours, shows educational films related to its exempt function in its theater. During the evening hours, it shows ordinary commercial pictures for an admission fee. The gross income produced during the evening hours is from unrelated trade or business and is derived from dual use of assets or facilities.

Section 1.513-1(d)(4)(iv) of the regulations is applicable to situations in which an organization has generated goodwill and other intangibles in the performance of its exempt activity that are exploited in a commercial endeavor that does not contribute importantly to the accomplishment of the organization's exempt purpose. The regulation illustrates this kind of income with an example of a scientific organization that has an excellent reputation in biological research and that regularly sells endorsements of various items of laboratory equipment. The selling of such endorsements does not contribute importantly to any of the organization's exempt purposes and the resulting income is classified as unrelated trade or business gross income derived from the exploitation of an exempt function.

In the instant case, the tennis camp's patrons are attracted to the school primarily for its capacity to provide suitable tennis facilities and personnel. Its reputation as an educational institution is of secondary importance, if a factor at all, in attracting the patrons. Thus, the school is not exploiting goodwill or other intangibles generated from the performance of its exempt function. The school is, however, using its educational facilities and personnel both for the accomplishment of its exempt purposes and for income-producing purposes that are unrelated to its exempt purposes.

Accordingly, the school's income from the summer tennis camp activity derives from dual use of facilities and personnel within the meaning of section 1.512(a)-1(c) of the regulations. Since dual use of facilities and personnel is involved, the allocable portion of expenses, depreciation, and similar items attributable to such facilities and personnel may be deducted in computing unrelated business taxable income under section 512 of the Code.

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26 CFR 1.512(a)-1: Definition.

Whether amounts received by a religious organization from several forest owners for whom it has contracted to perform services are unrelated business taxable income. See Rev. Rul. 76-341, page 307.

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26 CFR 1.512(a)-4: Special rules applicable to war veterans organizations.

Special rules for the determination of unrelated business income applicable to war veterans organizations. See T.D. 7438, page 156.

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26 CFR 1.512(b)-1: Exceptions, additions, and limitations.

Unrelated income; royalties received as patent owner. Amounts received from licensees by an exempt organization, the legal and beneficial owner of patents assigned to it by inventors for specified percentages of future royalties, constitute royalty income that is excludable in computing unrelated business taxable income; Rev. Rul. 73-193 distinguished.

Rev. Rul. 76-297

Advice has been requested whether, under the circumstances described below, amounts received by an organization subject to the provisions of section 511 of the Internal Revenue Code of 1954 constitute royalty income excluded in computing unrelated business taxable income within the meaning of section 512(b)(2).

The organization is exempt from Federal income tax under section 501(c)(3) of the Code. It was formed to promote scientific investigation and research at a university. In furtherance of this purpose, the organization makes annual grants to the university. In addition, the organization accepts inventions of individuals associated with the university for evaluation and possible patent consideration.

If the organization decides that an invention is a new discovery, it files a patent application. At that time the inventor executes an irrevocable assignment of both his legal and beneficial rights in the invention to the organization which in return agrees to pay a specified percentage of royalties subsequently received from licensees.

Section 512(a) of the Code provides that the term "unrelated business taxable income" means, with certain modifications, the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions. Section 512(b)(2) provides that in determining unrelated business taxable income there shall be excluded all royalties (including overriding royalties), whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

Section 1.512(b)-1 of the Income Tax Regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) of the Code shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment is not within the modification for rents.

Rev. Rul. 73-193, 1973-1 C.B. 262, holds that patent development and management service fees deducted by an organization exempt under section

501(c)(3) of the Code from royalties that are collected by it in its capacity as patent manager for the beneficial owners of patents do not retain the character of royalties in the organization's hands for purposes of section 512(b)(2). The organization holds bare legal title to the inventions for the account of the beneficial owners, i.e., educational and scientific institutions and the inventors on their staffs. The organization is entitled to retain for itself only an amount in payment for services rendered pursuant to an agreement to promote the inventions with respect to which it accepts legal title. Upon termination of the agreements, the inventions are assigned to the beneficial owners subject to any contracts that the organization may have entered into with respect to the inventions. As a result, income realized by the organization is not within the exception for royalty income provided by section 512(b)(2); instead, it is income received for patent development and management services.

Unlike the organization described in Rev. Rul. 73-193, the subject organization is both the beneficial and legal owner of its patents. Therefore, amounts paid to the organization pursuant to licensing agreements constitute royalty income, rather than fees for development and management services, as in Rev. Rul. 73-193.

Accordingly, amounts received by the organization from licensing fees constitute royalty income that is excludable by the organization in computing its unrelated business taxable income under section 512(b)(2) of the Code.

Rev. Rul. 73-193 is distinguished.

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26 CFR 1.512(b)-1: Exceptions, additions, and limitations.

Income derived by an exempt organization from mineral production payments acquired with borrowed funds. See Rev. Rul. 76-354, this page.

Section 513.—Unrelated Trade or Business

26 CFR 1.513-1: Definition of unrelated trade or business.

Whether an organization carrying on commercially sponsored scientific research is engaged in unrelated trade or business within the meaning of section 513 of the Code. See Rev. Rul. 76-296, page 141.

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26 CFR 1.513-1: Definition of unrelated trade or business.

Whether planting of seedlings is an unrelated trade or business. See Rev. Rul. 76-341, page 307.

Section 514.—Unrelated Debt-Financed Income

26 CFR 1.514(a)-1: Unrelated debt-financed income and deductions. (Also Sections 511, 512; 1.511-2, 1.512(b)-1.)

Debt-financed unrelated income; mineral production payments. The income derived by an exempt organization from mineral production payments purchased with borrowed funds constitutes unrelated business taxable income to the extent specified in section 514 of the Code.

Rev. Rul. 76-354

Advice has been requested whether, under the circumstances described below, income derived by an exempt organization from mineral production payments acquired with borrowed funds constitutes unrelated business taxable income to the extent specified in section 514(a) of the Internal Revenue Code of 1954.

The organization is exempt from Federal income tax under section 501(c)(3) of the Code and carries out its charitable purpose by making grants to other charitable organizations. To obtain income for its charitable program, the organization purchases mineral production payments with borrowed funds. From each production payment, the organization receives the difference between the aggregate amount payable to the lender of the borrowed funds and the total amount of the mineral production payment, which difference generally amounts to one-sixteenth of 1 percent of each production payment purchased.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from Federal income tax under section 501(c)(3).

Sections 512(b)(4) and 514(a)(1) of the Code provide that a portion of the income derived from, or on account of, each debt-financed property shall be included as an item of gross income derived from an unrelated trade or business.

Section 514(b) of the Code defines "debt-financed property" to mean, with certain exceptions not here relevant, any property which is held to produce income and with respect to which there is an "acquisition indebtedness" at any time during the taxable year.

Section 514(c) of the Code defines "acquisition indebtedness" as the unpaid amount of indebtedness incurred in acquiring or improving the property.

In this case, the organization incurs indebtedness to purchase mineral production payments. Therefore, the indebtedness constitutes an "acquisition indebtedness" within the meaning of section 514(c) of the Code. Accordingly, the mineral production payments are debt-financed property within the meaning of section 514(b) and the income derived therefrom is unrelated business taxable income to the extent specified in section 514(a).

Part IV.—Farmers' Cooperatives

Section 521.—Exemption of Farmers' Cooperatives From Tax

26 CFR 1.521-1: Farmers' cooperative marketing and purchasing associations; requirements for exemption under section 521.

Cooperatives; farmers; hedging

transactions for patrons. An exempt farmers' cooperative may in certain circumstances establish a commodity trading division to serve as a commodity broker to facilitate hedging transactions for its marketing patrons without affecting its exemption.

Rev. Rul. 76-298

Advice has been requested whether certain commodity trading activities that the taxpayer, a farmers' cooperative exempt from tax under section 521 of the Internal Revenue Code of 1954, proposes to engage in will affect its exemption under section 521.

The taxpayer proposes to establish a commodity trading division to serve as a commodity broker for its marketing patrons and thereby enable them to obtain higher and more secure profits from their farming operations. Brokerage accounts will be established pursuant to contract. The taxpayer proposes through this division to serve as a commodity broker to facilitate hedging transactions for its marketing patrons.

The commodity trading division will be managed as a separate department or division of the cooperative, and the share of the cooperative's net margins allocated to that division will be paid out in accordance with the by-laws of the taxpayer as patronage dividends to all patrons of the division, members and nonmembers alike, pursuant to binding obligations existing at the time the relevant transactions are entered into.

Section 521(b)(1) of the Code defines exempt farmers' cooperatives as farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) 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.

The proposed hedging transactions do not, in and of themselves, constitute marketing since the vast majority of the hedging transactions are not intended to be consummated by delivery. However, hedging may be an activity that is incidental to the marketing function of the taxpayer. It is a method of guaranteeing that the producer patrons will be protected from downward price shifts in the case of products that are marketed through the taxpayer.

Accordingly, the proposed hedging activity done exclusively with current and active patrons will not affect the taxpayer's exemption under section 521 of the Code.

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26 CFR 1.521-1: Farmers' cooperative marketing and purchasing associations; requirements for exemption under section 521.

Farmers' cooperative; patronage dividends; nonpatrons. An exempt farmers' cooperative making emergency purchases and purchases of sideline products for fixed prices from a nonmember nonproducer is not required to pay patronage dividends to the nonmember to maintain its exempt status.

Rev. Rul. 76-388

Advice has been requested whether, under the circumstances described below, patronage dividends must be paid to certain nonmember nonproducers in order for a farmers' cooperative marketing association to maintain its exemption from Federal income tax under section 521 of the Internal Revenue Code of 1954.

The taxpayer, a cooperative exempt from tax under the provisions of section 521 of the Code, is engaged in the marketing of different agricultural products of its patrons and in the purchasing of supplies and equipment for its patrons.

In the year 1974, due to an area crop failure, the taxpayer purchased products from nonmember nonproducers and marketed these products. These emergency purchases were made for the sole purpose of meeting preexisting contractual commitments. *See* Rev. Rul. 69-222, 1969-1 C.B. 161, which holds that the exempt status of a farmers' cooperative will not be adversely affected by emergency purchases from nonproducers to fulfill outstanding orders based on normal crop expectations.

The cooperative also purchased a limited amount (5 percent) of nonmember nonproducer items for the purpose of facilitating the normal sale of producer items. The retail sale of these items was incidental to the marketing of the cooperative's normal agricultural products. *See* Rev. Proc. 67-37, 1967-2 C.B. 668, which provides guidelines for determining the effect of retail selling of nonproducer items sold by an exempt farmers' cooperative as a sideline to facilitate the sale of products produced by the cooperative's patrons.

Section 521(b)(1) of the Code provides, in part, for an exemption from Federal income tax for farmers', fruit growers', or like associations organized and operated on a cooperative basis for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them.

Section 521(b)(4) of the Code provides, in part, that exemption shall not be denied any such association that markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members.

Section 1.521-1(a)(1) of the Income Tax Regulations provides, in part, that nonmember patrons must be

treated the same as members insofar as the distribution of patronage dividends is concerned. Thus, if products are marketed for nonmember patrons, the proceeds of sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association.

Section 1.1388-1(e) of the regulations defines a patron as any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

A patron bears the risk of loss from dealings with the cooperative, but the nonmember nonproducers described above bear no such risk. In dealing with the cooperative, the nonmember nonproducers receive a fixed price for their products that is not dependent upon the price subsequently received by the cooperative upon marketing the products. Thus, nonmember nonproducers who are entering into transactions with the cooperative are not patrons of the cooperative since they do not engage in business with the cooperative on a cooperative basis. The activities described in the instant case, that is, the purchase of sideline products and emergency purchases, are commercial transactions not involving utilization of the cooperative function.

Accordingly, patron status is not attained by those selling such items to the cooperative, and patronage dividends need not be paid to these nonpatrons. The profits attributable to these transactions will be nonpatronage sourced earnings subject to section 521(b)(4) of the Code.

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26 CFR 1.521-1: Farmers cooperative marketing and purchasing associations; requirements for exemption under section 521.

Procedures with respect to applications for recognition of exemption from income tax and revocation or modification of exemption rulings and determination letters under section 521 of the Code. See Rev. Proc. 76-33, page 655.

Subchapter G.—Corporations Used to Avoid Income Tax on Shareholders
Part II.—Personal Holding Companies

Section 542.—Definition of Personal Holding Company

26 CFR 1.542-1: General rule.

Whether the amount includible in the gross income of a domestic corporation under section 951(a)(1)(B) of the Code retains the character it had when realized by its controlled foreign corporations, for purposes of determining whether the domestic corporation is a personal holding company under section 542. See Rev. Rul. 76-403, page 229.

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26 CFR 1.542-2: Gross income requirement.

Whether dividends received by a parent corporation from its wholly owned life insurance company subsidiary should be treated as personal holding company income under the circumstances described. See Rev. Rul. 76-320, below.

Section 543.—Personal Holding Company Income

26 CFR 1.543-1: Personal holding company income.
(Also Sections 61, 542, 1502; 1.61-9, 1.542-2, 1.1502-14.)

Personal holding company income; life insurance company dividends to affiliated group member. Dividends received during taxable years beginning before 1974 by a member of an affiliated group from its wholly owned life insurance subsidiary, excluded from the affiliated group by section 1504(b)(2) of the Code, are includible in the parent's income as personal holding company income for purposes of meeting the definition of a personal holding company under section 542(a)(1). Dividends received during taxable years beginning after 1973, however, are excludable from the parent's income for purposes of this section. Rev. Rul. 71-531 distinguished.

Rev. Rul. 76-320

Advice has been requested whether, under the circumstances described below, dividends received by a corporation should be treated as personal holding company income for purposes of section 543(a)(1) of the Internal Revenue Code of 1954.

P is a domestic corporation that owns all the outstanding stock of its subsidiaries, *M* and *S*. *P* and *S* filed consolidated Federal income tax returns for 1971. *M* is a life insurance company subject to tax under section 802 of the Code. *M* filed separate Federal income tax returns for 1971, as *M* was not an "includible corporation" in the affiliated group pursuant to section 1504(b)(2).

During the last half of 1971, more than 50 percent in value of *P's* outstanding stock was owned, directly or indirectly, by three individuals. *M*, a life insurance company, is excluded from the definition of a personal holding company under the provisions of section 542(c)(3) of the Code. During the calendar year 1971, *M* paid dividends on its outstanding capital stock to *P* that were includible in *P's* gross income under section 61.

The specific question is whether the dividends paid by *M* in 1971 are includible in *P*'s income as personal holding company income for purposes of meeting the definition of a personal holding company under section 542(a)(1) of the Code.

Section 61(a) of the Code provides, in part, that gross income means all income from whatever source derived including, but not limited to, dividends.

Section 1.61-9 of the Income Tax Regulations provides that, unless otherwise specifically provided, dividends are included in gross income under section 61 of the Code.

Section 543(a)(1) of the Code provides, in part, that for purposes of subtitle A, the term "personal holding company income" means that portion

of the adjusted ordinary gross income that consists of items that include dividends.

Section 542(a) of the Code defines a personal holding company to mean any corporation, subject to certain exceptions, if (1) at least 60 percent of its adjusted ordinary gross income is personal holding company income, as defined in section 543(a), and (2) at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

Rev. Rul. 71-531, 1971-2 C.B. 242, holds that dividends paid by a bank to its parent company during a consolidated return year are eliminated for purposes of determining the parent's separate personal holding company income. In Rev. Rul. 71-531 both corporations were members of the affiliated group filing a consolidated return, and the issue was whether, for purposes of determining the personal holding company income of the parent, the general rule of section 1.1502-14(a)(1) of the regulations should apply to eliminate dividends from gross income where the distributing member was a bank and was not itself a personal holding company.

A life insurance company, like the bank in Rev. Rul. 71-531, is excluded from the definition of a personal holding company under section 542(c) of the Code. Unlike that bank, the insurance company, as previously stated, is excluded from filing consolidated returns with the affiliated group under section 1504(b)(2). Consequently, section 1.1502-14(a)(1) of the regulations cannot apply to dividends paid by *M* and received by *P*. Therefore, *P* must look to other provisions of the Code and regulations to determine if such dividends are includible in its gross income. Under section 1.61-9 the dividends received by *P* from *M* during the calendar year 1971 are includible in *P*'s gross income.

However, effective for taxable years beginning after December 31, 1973, *Pub. L. No. 93-480,* 1974-2 C.B. 442, amended section 542(b) of the Code (relating to corporations filing consolidated returns) by adding paragraph (5), which reads as follows:

> (5) Certain Dividend Income Received From A Nonincludible Life Insurance Company.—In the case of an affiliated group of corporations filing or required to file a consolidated return under section 1501 for any taxable year, there shall be excluded from consolidated personal holding company income and consolidated adjusted ordinary gross income for purposes of this part dividends received by a member of the affiliated group from a life insurance company taxable under section 802 that is not a member of the affiliated group solely by reason of the application of paragraph (2) of subsection (b) of section 1504.

Accordingly, in the instant case dividends paid to *P* by *M* during the calendar year 1971 are includible in *P*'s gross income for purposes of meeting the definition of a personal holding company under section 542(a)(1) of the Code. However, if the dividends had been paid during a taxable year beginning after December 31, 1973, section 542(b)(5) would have been applicable and such dividends would have been excluded from *P*'s gross income for purposes of section 542(a)(1).

Rev. Rul. 71-531 is distinguished.

Subchapter H.—Banking Institutions
Part I.—Rules of General Applications to Banking Institutions

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Section 581.—Definition of Bank

26 CFR 1.581-1: Tax on banks.

Whether section 1.1502-14(d) of the regulations (dealing with stocks, bonds, and other obligations of members) operates to defer and not currently allow a deduction for an addition to a reserve for bad debts under section 166(c) of the Code computed under section 585(b)(2). See Rev. Rul. 76-430, page 183.

Section 584.—Common Trust Funds

26 CFR 1.584-1: Common trust funds.

Rev. Rul. 76-326

A bank holds assets as a custodian under a state statute corresponding to the Uniform Gift to Minors Act. Section 584 of the Internal Revenue Code of 1954 provides, in part, that the term "common trust fund" means a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian. *Held,* the bank as custodian under the state statute corresponding to the Uniform Gift to Minors Act is not acting in one of the fiduciary relationships specifically enumerated in section 584 of the Code. *Held further,* funds held by the bank as custodian under the state statute corresponding to the Uniform Gift to Minors Act are not eligible for participation in a common trust fund maintained by the bank under the provisions of section 584 of the Code.

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26 CFR 1.584-1: Common trust funds.

Estates and trusts; common trust fund; transfer of interest. The transfer of units of participation in a common trust fund from the estate of a decedent to a testamentary trust of the same decedent by the bank that maintained the trust fund and also acted as executor of the estate and trustee of the testamentary trust was not a withdrawal of a participating interest to be treated as a sale or an exchange.

Rev. Rul. 76-532

Advice has been requested whether, under the circumstances described below, the transfer of units of participation in a common trust fund from the estate of a decedent to a trust created by the will of the decedent was a withdrawal of a participating interest by a participant in the common trust fund within the meaning of section

584(e) of the Internal Revenue Code of 1954.

A died leaving an estate composed primarily of shares of common stock. *M*, a bank, was named under *A*'s will as executor of the estate and as trustee of a trust created by *A*'s will. *M* is also a banking institution maintaining a common trust fund, *X*, as defined in section 584(a) of the Code.

Prior to creating and funding the trust, *M*, exercising its fiduciary duties as executor, sold the shares of stock comprising the estate. A portion of the proceeds from the sale were used for the payment of taxes and other administration expenses. The portion not needed for such expenses was invested by *M* in *X*, and *M* as executor of the estate received units of participation in *X* in the name of the estate. At such time as the trust created under the will was funded, *M* transferred all the units of participation in *X* that were in the name of the estate to the name of the trust. In order to make the transfer of the units of participation from the estate to the trust, *M* only had to make a bookkeeping entry indicating that the owner of the units was the trust rather than the estate. The estate received nothing for the transfer of the units of participation.

Section 584(e) of the Code provides, in part, that no gain or loss shall be realized by a common trust fund by the admission or withdrawal of a participant, but that the withdrawal of any participating interest by a participant shall be treated as a sale or exchange of such interest by the participant.

Section 1.584-1 of the Income Tax Regulations defines participant as any trust or estate the moneys of which have been contributed to a common trust fund.

In the instant case, the transfer of the units of participation in fund *X* from the estate to the trust upon the funding of the trust required no funds to change hands but only the making of the bookkeeping entry by *M*, the executor and the trustee, indicating that the trust was the owner of the units of participation. In addition, the transfer did not involve the receipt of any consideration by the estate or a beneficiary therof. See Rev. Rul. 60-256, 1960-2 C.B. 193.

Accordingly, the transfer by *M* of units of participation in *X* from the estate to the trust upon funding of the trust was not a withdrawal of a participating interest within the meaning of section 584(e) of the Code.

Section 585.—Reserves for Losses on Loans of Banks

(Also Sections 166, 581, 1502, 1504; 1.166-1, 1.581-1, 1.1502-14, 1.1504-1.)

Reserve for bad debts; loans made by banks to affiliated corporations. Section 1.1502-14(d) of the regulations prohibits an affiliated group filing a consolidated Federal income tax return from claiming a current deduction under section 166(c) of the Code for additions to reserves for bad debts computed under section 585 to the extent that such additions relate to loans from a bank member to another member of the group.

Rev. Rul. 76-430

Advice has been requested whether, under the circumstances described below, section 1.1502-14(d) of the Income Tax Regulations (dealing with stocks, bonds, and other obligations of members) operates to defer and not currently allow a deduction for an addition to a reserve for bad debts under section 166(c) of the Internal Revenue Code of 1954 computed under section 585(b)(2).

P is a bank as defined in section 581 of the Code. *S* is engaged in a separate business. *P* and *S* are members of an "affiliated group", as that term is defined in section 1504(a), that filed a consolidated Federal income tax return for the taxable year 1974. *P* employs the reserve method of accounting for bad debts under section 166(c) and computes its current addition to the reserve for bad debts under section 585.

During the taxable year 1974, *P* made cash loans to *S* and included such loans in its loan base in computing its current addition to the reserve for bad debts for 1974.

Section 166(c) of the Code provides that in lieu of any deduction under section 166(a), there shall be allowed in the discretion of the Secretary of the Treasury or the Secretary's delegate a deduction for a reasonable addition to a reserve for bad debts.

Section 585 of the Code provides the rules for computing the reasonable additions to the reserve for bad debts for financial institutions such as *P*.

Section 1.1502-14(d)(1) of the regulations provides that to the extent gain or loss is recognized under the Code to a member during a consolidated return year because of a sale or other disposition (other than a redemption or cancellation) of an obligation of a debtor-member, whether or not such obligation is evidenced by a security, such gain or loss shall be deferred. For purposes of this provision, section 1.1502-14(d)(1) further provides that a deduction because of the worthlessness of, or a deduction for a reasonable addition to a reserve for bad debts with respect to, an obligation in this subparagraph shall be considered a loss from the disposition of such obligation.

Section 1.1502-14(d)(2) and (3) of the regulations describe events that require the restoration of deferred gain or loss by members of an affiliated group.

Section 1.1502-80 of the regulations provides, in part, that the Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application.

Section 1.1502-14(d)(1) of the regulations overrides the deduction allowed to banks under section 166(c) of the Code, computed under section 585, in the instance of loans to affili-

ated corporations and operates to defer, and thus not currently allow banks filing consolidated returns to claim current deductions under section 166(c) for additions to reserves for bad debts computed under section 585 to the extent that such additions relate to loans to affiliated corporations.

Accordingly, the portion of *P*'s addition to its bad debt reserve applicable to loans to *S*, which is computed under section 585 of the Code, is treated as a loss from the disposition of the loans to *S* pursuant to section 1.1502-14 (d)(1) of the regulations. Such loss will be deferred until some restoration event described in section 1.1502-14 (d)(2) or (3) takes place. The amount that must be deferred will be computed as follows: compute the section 585 bad debt reserve addition by including loans to an affiliate in *P*'s eligible loans outstanding, and then reduce such amount by the section 585 bad debt reserve addition computed by excluding such loans to an affiliate from *P*'s eligible loans outstanding; the balance is the amount that must be deferred.

Part II.—Mutual Savings Banks, etc.

Section 594.—Alternative Tax for Mutual Savings Banks Conducting Life Insurance Business

26 CFR 1.594-1: Mutual savings banks conducting life insurance business. (Also Sections 11, 802, 1563; 1.11-1, 1.802-3, 1.1563-1.)

Surtax exemption; mutual savings bank conducting life insurance business. A mutual savings bank that conducts a life insurance business in a separate department is entitled to compute the alternative tax under section 594 of the Code using the full surtax exemption under section 11(d) in determining both the partial tax on the income of the insurance department and the partial tax on the income of the banking department before adding the two partial taxes to determine its overall tax; Rev. Rul. 71-386 distinguished.

Rev. Rul. 76-476

Advice has been requested whether a mutual savings bank that conducts a life insurance business in a separate department is entitled to compute the alternative tax for such organizations, under section 594 of the Internal Revenue Code of 1954, utilizing the surtax exemption under section 11(d) in determining both the partial tax on the income of the insurance department and the partial tax on the income of the banking department, before adding the two partial taxes to determine the overall tax under section 594.

The taxpayer is a mutual savings bank of the type described in section 594 of the Code that conducts life insurance business in a separate department. In computing its Federal income taxes for the calendar year 1975, the taxpayer utilized separate surtax exemptions of $50,000 under section 11(d) in computing the partial taxes for both the banking department and the life insurance department.

Section 594(a) of the Code provides as follows:

> (a) Alternative Tax.—In the case of a mutual savings bank not having capital stock represented by shares, authorized under State law to engage in the business of issuing life insurance contracts, and which conducts a life insurance business in a separate department the accounts of which are maintained separately from the other accounts of the mutual savings bank, there shall be imposed in lieu of the taxes imposed by section 11 or section 1201(a), a tax consisting of the sum of the partial taxes determined under paragraphs (1) and (2):
>
> (1) A partial tax computed on the taxable income determined without regard to any items of gross income or deductions properly allocable to the business of the life insurance department, at the rates and in the manner as if this section had not been enacted; and
>
> (2) a partial tax computed on the income of the life insurance department determined without regard to any items of gross income or deductions not properly allocable to such department, at the rates and in the manner provided in subchapter L (sec. 801 and following) with respect to life insurance companies.

Section 1.594-1(b) of the Income Tax Regulations provides, in part, that in the case of a mutual savings bank conducting a life insurance business to which section 594 of the Code is applicable, the tax upon such bank consists of the sum of the two partial taxes.

Section 11(a) of the Code states that a tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under section 11(b) and a surtax computed under section 11(c).

Section 11(e) of the Code provides that the prescribed tax on corporate income under section 11 is not applicable to mutual savings banks subject to tax under section 594. Section 594 specifically states that the alternative tax is to be made "in lieu of" the tax imposed under section 11.

Section 1.802-3(d) of the regulations provides, in part, that in determining the tax imposed on life insurance companies the surtax is computed by applying the regular corporate surtax rate provided by section 11(c) of the Code to the amount by which the life insurance company taxable income exceeds the surtax exemption for the taxable year as determined under section 11(d).

Sections 1561 through 1564 of the Code restrict certain groups of commonly controlled corporations from obtaining multiple surtax exemptions. However, in defining which companies are members of a controlled group, section 1563(b)(2)(D) specifically excludes life insurance companies except when two or more life insurance companies are members of a controlled group.

Rev. Rul. 71-386, 1971-2 C.B. 59, provides that the investment credit for qualified depreciable property allowed under section 38 of the Code is creditable against the total tax liability of a mutual savings bank conducting a life insurance business under section 594 and not simply against

the partial tax of either of its departments. The rationale for Rev. Rul. 71-386 is that section 38 prescribes that the credit is against the tax "imposed under" chapter 1 of the Code, which in the case of a section 594 corporation is its total tax liability, not the constituent partial taxes.

Section 594 of the Code and the regulations thereunder state that the determination of each partial tax is to be made "without regard" to the partial tax of the other deparment. These provisions further state that the partial tax on the life insurance department should be made under subchapter L as if it were a separate life insurance company. Under subchapter L, a life insurance company is entitled to a surtax exemption. Section 1.802-3 of the regulations. Similarly, the partial tax on the banking department is to be determined under the ordinary corporate income tax provisions of section 11, without regard to the separate tax on the life insurance department. Section 1.594-1(b)(1).

There is no indication in section 594 of the Code or the regulations thereunder that the determination of these partial corporate taxes under section 11 or subchapter L are to be made in any manner different from the ordinary methods applicable for separate corporations or that the surtax exemption is to be utilized in a different manner in determining these partial taxes. To interpret the surtax exemption as being applicable only to the sum or only to one of the two partial taxes would require the implication of a limitation on the specific language of section 594 that the partial taxes be determined "without regard" to each other, or a limitation in the provisions of either subchapter L or section 11 so as to limit the right to utilize the surtax exemption when computing the partial taxes under these provisions.

A main purpose of section 594 is to tax the life insurance department of a mutual savings bank as if it were a separate life insurance company. *See H.R. Rep. No. 1179,* 82d Cong., 1st Sess. 85 (1951). The Joint Committee's report on this provision states that it provides for the separate taxation of the bank's life insurance department as if this department were a separate corporation from the banking activities. *Joint Committee on Internal Revenue Taxation, Summary of the Provisions of the Revenue Act of 1951,* 82d Cong., 1st Sess. 17 (1951), 1951-2 C.B. 287, 300. If the surtax exemption were not available in determining the partial tax of the insurance department, this department could not be considered as a separate corporation in an ordinary sense.

This Congressional intent was reaffirmed in the legislative history of the Life Insurance Company Income Tax Act of 1959, 1959-2 C.B. 654, which made substantial changes in the taxation of life insurance companies. The Senate Report states that whenever this Act refers to life insurance companies, it encompasses life insurance departments of mutual savings banks. The report notes that such mutual savings banks are taxed by section 594 of the Code under a "substitute tax" consisting of a partial tax on the banking activities and a partial tax on the insurance department, the latter computed in the "same manner as for a separate life insurance company." *S. Rep. No. 291,* 86th Cong., 1st Sess. 37, 38 (1959), 1959-2 C.B. 770, 797. Thus, the legislative history indicates that Congress intended that the partial tax under section 594 on the insurance department should be computed like a separate ordinary life insurance company, which would be entitled to utilize the surtax exemption.

Rev. Rul. 71-386 is distinguishable from the instant case since the language of section 38 of the Code makes the investment credit a set-off against the total tax imposed under section 594, which is the sum of the two partial taxes, while the surtax exemption is a set-off against income, which under section 594 can only be the income of the separate departments upon which the partial taxes are computed. Thus, it would be mechanically inconsistent with the language of section 594 to apply the surtax exemption against the overall tax on the section 594 bank, whereas the language of section 38 clearly does make the investment credit a set-off against the overall tax.

Accordingly, the taxpayer is entitled to compute the alternative tax under section 594 of the Code, utilizing the full surtax exemption under section 11(d) in determining the partial tax on the income of the insurance department and a full surtax exemption in determining the partial tax on the income of the banking department, before adding the two partial taxes to determine the overall tax under section 594.

Rev. Rul. 71-386 is distinguished.

Subchapter I.—Natural Resources
Part I.—Deductions

Section 611.—Allowance of Deduction for Depletion

26 CFR 1.611-1: Allowance of deduction for depletion.

Depletion; sand and gravel; state owned deposits. Acquiescence in **Victory Sand and Concrete, Inc.** is based solely on the court's holding that the taxpayer had acquired an economic interest in the state-owned sand and gravel deposits, which were being depleted, because it was operating under a binding contract with the state. Such acquiescence is not an acceptance of the court's holding that the taxpayer had acquired an economic interest in the deposits because of its mere ownership of the adjacent land.

Rev. Rul. 76-484

As a result of the decision of the

United States Tax Court in the case of *Victory Sand and Concrete, Inc.*, 61 T.C. 407 (1974), *acq.*, 1974-2 C.B. 4, advice has been requested whether the Internal Revenue Service agrees with the basis upon which the court reached the conclusion that the taxpayer, Victory, acquired an economic interest in state owned sand and gravel deposits.

Under the facts in *Victory Sand and Concrete, Inc.*, Victory owned a parcel of land with river frontage from which it extracted sand and gravel from the bed of the Kansas River for onshore processing. Title to the sand and gravel deposits in the river bed was in the State of Kansas, and Victory contracted with the State for the exclusive right to extract sand and gravel within a defined area. Under the contract, the extracted sand and gravel became the property of Victory, subject to a royalty paid the state on each ton of material sold. The State could cancel the contract only if Victory failed to pay the designated royalty within a specified time. Under State law, Victory was also required to secure a permit, renewable yearly, from the Division of Water Resources, Kansas State Board of Agriculture, to make changes in the bed and flow of the river.

In years prior to 1967, the sand and gravel deposits being extracted were replaced by sediments carried down by the river and its tributaries. For those years, Victory did not claim a deduction for depletion. Beginning in 1967, a series of flood control dams were constructed on the river and its tributaries which, Victory claimed and the court found, stopped the replenishment of coarse sand and gravel, depositing only fine sands, mud, and silt.

The issues before the court were whether the sand and gravel deposits extracted from the riverbed by Victory actually were being depleted during taxable years after 1967, and whether Victory had acquired an economic interest in those deposits.

The court found that the building of the dams had prevented the replenishment of the coarser sand and gravel, and that the deposits were being depleted. The court also held that Victory had acquired an economic interest in the deposits, both by reason of its ownership of the adjacent land and by reason of its binding contract with the State.

In holding that Victory had acquired an economic interest in the deposits, the court considered ownership of the adjacent land as necessary to the extraction of the sand and gravel, citing decisions in *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956), 1956-1 C.B. 614, and *Oil City Sand and Gravel Co.*, 32 T.C. 31 (1959), *nonacq.*, 1965-2 C.B. 7.

In *Southwest Exploration Co.*, the primary issue was whether Southwest or the upland owners were entitled to percentage depletion with respect to net profits paid to the upland owners. In that case, the upland owners had entered into an agreement with Southwest whereby they contributed the use of their property for offshore oil exploitation in return for a share in the net profits from the oil deposits. The Supreme Court of the United States held that where, in the circumstances of this case, a party essential to the drilling for and extraction of oil has made an indispensable contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received.

The upland owners in *Southwest Exploration Co.* could expect a return on their investment only from the production of oil from the deposits. It was not the mere ownership or use of the land that created the economic interest, but it was the contribution by the upland owners of the use of the land in exchange for a net profits interest in the oil produced that conveyed to them the economic interest. Realization of income from the net profits interest could arise only from the extraction and sale of the oil.

In Oil City, a taxpayer was extracting sand and gravel from state owned riverbed deposits without lease, contract, or payment of royalties. However, the taxpayer was required to obtain and did obtain the required permits having to do only with property damage and navigation on the river from the United States Army Corps of Engineers and the state's Department of Forests and Waters. These permits did not grant any title or any other rights to the mineral. The taxpayer claimed and the court so found that the deposits were being depleted, and that it had acquired an economic interest in the deposits because it owned the only two parcels of riparian land from which its particular method of operation could economically and physically be conducted, due to the shoaling (shallowness) of the river upstream and downstream from each location. The court, basing its decision on *Southwest Exploration Co.*, found that this gave Oil City physical and economic control of the deposits and constituted an economic interest.

Section 1.611-1(b) of the Income Tax Regulations provides, in part, that annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits and that an economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place and secures, by any form of legal relationship, income derived from the extraction of the mineral to which the taxpayer must look for a return of capital.

In *Victory Sand and Concrete, Inc.*, as in *Oil City*, the court did not recognize that the major distinction in *Southwest Exploration Co.* was that the upland owners in *Southwest Exploration Co.* had acquired an economic interest, within the meaning of the Code and the regulations thereunder, by reason of the indispensable

contribution of the use of their land in exchange for a share of the net profits in the oil deposits. It was not the use of the land but it was the acquisition of the right to share in the proceeds from production of oil that created the economic interest. In *Oil City* and *Victory Sand and Concrete, Inc.*, there was no such investment by contribution of land for acquisition of rights to the mineral or proceeds of the mineral. The use of the land did not establish a legal relationship whereby the taxpayer in these cases acquired a right to a share of mineral from one who has all rights to such mineral. The Service does not consider that mere ownership of land adjacent to minerals that are owned by others confers any economic interest in such minerals.

Therefore, the court's reliance on *Southwest Exploration Co.*, in *Victory Sand and Concrete, Inc.*, was not justified because the cases are factually distinguishable. However, the court in *Victory Sand and Concrete, Inc.* also based its holding on the fact that the contract with the state gave Victory the exclusive right to extract sand and gravel, which, in this instance, has been found to be a wasting asset, from a defined area of the riverbed and to use or sell the extracted material subject only to a royalty paid the state. The conveyance of those rights, not being terminable at will, created the taxpayer's economic interest in the riverbed deposits. This contractual right with the state also distinguishes *Victory Sand and Concrete, Inc.* from *Oil City Co.*

Accordingly, acquiescence by the Service in the decision in *Victory Sand and Concrete, Inc.* is based solely on the court's holding that Victory had acquired an economic interest in the state owned sand and gravel deposits, which were being depleted, because it was operating under a binding contract with the state, and such acquiescence is not an acceptance of the court's holding that Victory had acquired an economic interest in the deposits because of its mere ownership of the adjacent land. Thus, acquiescence in result is substituted for acquiescence in *Victory Sand and Concrete, Inc.*, page 3, this Bulletin.

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26 CFR 1.611-1: Allowance of deduction for depletion.

Depletion; sand and gravel; dredging operations in navigable waters. A taxpyayer who dredges sand and gravel from the bed of a navigable river under a permit from the Federal Government that merely constitutes a waiver by the U.S. of any objection based on control over navigation, but that does not otherwise give the taxpayer any legal right or economic interest in the deposit, is not entitled to percentage depletion unless the taxpayer has a depletable economic interest in the deposit independent of such Federal permit; Rev. Rul. 55-251 superseded.

Rev. Rul. 76-485

Advice has been requested whether a deduction for depletion on sand and gravel dredged for commercial sale from the bed of a navigable river is allowable for Federal income tax purposes under the circumstances described below.

The taxpayer dredges sand and gravel from several rivers and sells it to various industrial concerns in the area. The taxpayer pays no royalties for the sand and gravel that the taxpayer removes and sells. The operation is carried on under a permit from the United States Army Corps of Engineers, but the taxpayer has no express permission of any kind from the state government to remove the sand and gravel. The permit from the Corps of Engineers states that it is understood that "this instrument does not give any property rights either in real estate or material, or any exclusive privileges * * * nor does it obviate the necessity of obtaining state assent to the work authorized. It merely expresses the assent of the Federal Government so far as concerns the public rights of navigation." The permit is merely a waiver by the United States of any objection based on control by the United States over navigation.

Section 611(a) of the Internal Revenue Code of 1954 provides, in part, that there shall be allowed as a deduction in computing taxable income, in the case of mines and other natural deposits, a reasonable allowance for depletion.

Section 1.611-1(b) of the Income Tax Regulations provides, in part, that annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits and that an economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place and secures, by any form of legal relationship, income derived from the extraction of the mineral to which the taxpayer must look for a return of capital.

Section 1.611-1(d)(4) of the regulations provides that the term "mineral deposits" refers to minerals in place, and section 1.611-1(d)(5) provides that the term "minerals" includes ores of the metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from other inexhaustible sources.

Rev. Rul. 76-484, page 185, this Bulletin explains the circumstances under which an economic interest may be secured from a state. It provides that an economic interest in sand and gravel deposits in a river bed to which a state had title was conveyed under a binding contract, not terminable at will, which provided for the payment of royalties to the state.

The permit granted by the United States in the instant case does not give the taxpayer any property rights in the deposit, nor does it give the taxpayer a superior right in the deposits over anyone else.

Accordingly, a taxpayer who dredges sand and gravel from the bed of a navigable river under a permit from the Federal government that merely constitutes a waiver by the United States of any objection based on control by the United States over navigation, but that does not otherwise give to the taxpayer any legal right or economic interest in the deposit, is not entitled to percentage depletion unless the taxpayer has a depletable economic interest or legal right to the deposit independent of such Federal permit.

Rev. Rul. 55-251, 1955-1 C.B. 288, is hereby superseded, since the position stated therein is set forth under the current statute and regulations in this Revenue Ruling.

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26 CFR 1.611-3: Rules applicable to timber.

Depletion; reforestation expenditures. The expenditures for destroying undesirable hardwood trees and brush in naturally reforested stands of southern pine young growth are related to the seeding and establishment of the pine seedlings and are capital expenditures recoverable through depletion.

Rev. Rul. 76-290

Advice has been requested whether, under the circumstances described below, expenditures for control of unwanted hardwood trees in naturally regenerated (reforested) stands of southern pine young growth must be capitalized in accordance with section 1.611-3(a) of the Income Tax Regulations.

A taxpayer owns extensive areas of timberlands in the south and manages them for the continuous production of wood. Much of the land supports forest stands of the loblolly-shortleaf pine type. The species composition of these stands, other than the predominating loblolly pine (Pinus taeda) and shortleaf pine (Pinus echinata), includes a number of hardwoods. The hardwood species, because they are more shade tolerant than the pines, often form dense understories in the mature pine stands. The pine stands are considered by the taxpayer to be mature and ready for harvesting at age 40 years.

Most of the hardwood trees have little or no market value because of their defectiveness, poor form, or small size. When the merchantable trees in such stands are cut (harvested), the residual undesirable hardwoods soon dominate the site so that regeneration of the valuable loblolly-shortleaf pine forest is prevented unless effective measures are taken to control the hardwoods, either by eliminating them or reducing their growth and vigor.

The taxpayer's method of providing for the reforestation of an area is to harvest all the merchantable timber except for an average of six pine seed trees per acre. The expectation is that the seed trees will drop enough seeds to achieve an adequate stocking of pine reproduction (seedlings) within a period of 3 to 5 years. Although the taxpayer recognizes at the time that the merchantable timber is harvested that the hardwood trees and brush then existing will have to be controlled in order to allow the new pine seedlings to grow to a commercially salable size, the performance of control activities is deferred by the company until after the adequacy of the stocking of pine seedlings can be determined.

If the taxpayer finds, within 3 to 5 years after the harvest cut, that the stocking of pine seedlings is inadequate for the regeneration of the loblolly-shortleaf forest, the taxpayer resorts to artificial reforestation. This is accomplished by first harvesting the pine seed trees, and then preparing the site for planting by eliminating or controlling the undesirable hardwood trees through the use of fire or chemicals, or by mechanical means. Finally, nursery grown pine seedlings are planted. The costs of such site preparation and planting of seedlings are capitalized by the taxpayer in accordance with the provisions of section 1.611-3(a) of the regulations.

If, however, the taxpayer finds that within 3 to 5 years after the harvest cut, an adequate stocking of pine seedlings has been achieved, the natural regeneration of the loblolly-shortleaf forest is considered to be feasible. The pine seed trees are then harvested and the taxpayer inspects the stand of young seedlings to determine the nature and extent of the work that must be done to control the undesirable hardwood trees so that they will not dominate the area to the exclusion of the more valuable pines. Implementation of the control procedures in the naturally reforested areas is usually undertaken by the taxpayer when the pine young growth is from 3 to 7 years old.

Various procedures may be used to accomplish the hardwood control. Mechanical or chemical methods are generally used to destroy or weaken the undesirable hardwoods. On the larger undesirable hardwood trees, a manually operated poison injector may be used. Regardless of the procedure used the objective is the same, to prevent the undesirable residual hardwood trees from dominating the site at the expense of the pine young growth. Such control procedures are a one-time endeavor with respect to each new stand of pine seedlings rather than a recurring type of activity.

Section 1.611-3(a) of the regulations provides, in part, that amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recovered through depletion allowances. Such amounts include, for example, expenditures made for preparation of the timber site for planting or for natural seeding and the cost of seedlings.

Rev. Rul. 66-18, 1966-1 C.B. 59, provides that brush removal work performed a year or two after the planting of Christmas tree seedlings is considered to be proximately related to the establishment of the seedlings. Such

work is essentially a part of the planting operation, and its cost is to be capitalized.

Rev. Rul. 75-467, 1975-2 C.B. 93, holds that direct costs incurred in connection with reforestation by planting are capital expenditures. That Revenue Ruling provides specifically that one category of such expenditures is preparation of the site, including any girdling or brush removal work to afford good growing conditions. The term "girdle" means to encircle the stem of a living tree with cuts that completely sever bark and cambium and often are carried well into the outer sapwood, for the purpose of killing the tree.

The taxpayer's hardwood control activities accomplish the same purpose as the girdling referred to in Rev. Rul. 75-467, and are comparable to the site preparation work referred to in that Revenue Ruling and in Rev. Rul. 66-18.

Accordingly, in the instant case, the expenditures made for control of unwanted hardwood trees and brush in naturally regenerated stands of southern pine young growth are proximately connected with the seeding and establishment of the pine seedlings and must be capitalized in accordance with section 1.611-3(a) of the regulations.

Section 613.—Percentage Depletion

26 CFR 1.613-1: Percentage depletion; general rule.
(Also Section 446; 1.446-1.)

Depletion; oil and gas; year of deduction. An accrual method taxpayer who produces oil, transports it to a storage tank off the premises from which it is produced, and sells it in a later year must take into account a deduction for depletion in the taxable year of sale.

Rev. Rul. 76-533

Advice has been requested as to the taxable year in which percentage depletion should be taken into account by a taxpayer when the oil is moved off the premises from which produced and is stored prior to sale.

The taxpayer, who uses the accrual method of accounting, produced oil from a property in which the taxpayer possessed the economic interest. None of the oil was used by the taxpayer on the premises, nor was it further processed by the taxpayer. Instead the taxpayer moved the oil to a storage tank off the premises from which the oil was produced and continued to own the oil while it was in the storage tank. The oil was sold in the following taxable year.

The taxpayer claimed a deduction under section 1.613-3(a) of the Income Tax Regulations for depletion with respect to the oil in question in the year of production rather than the year of sale.

Section 1.446-1(c)(1)(ii) of the regulations specifies that under the accrual method, income is to be included for the taxable year when all events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Section 1.613-3(a) of the regulations provides:

> In the case of gas and oil wells, "gross income from the property," as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

Rev. Rul. 68-565, 1968-2 C.B. 263, holds that an owner-lessor of a mineral property should take a deduction for allowable depletion in the year of receipt of royalty income (if on the cash receipts and disbursements method of accounting) or in the year of accrual (if on the accrual method of accounting).

The Revenue Ruling provides that under the accrual method discussed in section 1.446-1(c)(1)(ii) of the regulations, income is to be included for the taxable year when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy and that since the time of deduction for depletion is correlated to income, the owner-lessor should deduct the allowable depletion in the year of accrual.

Rev. Rul. 68-565 cited *Inspiration Consolidated Copper Company v. Commissioner*, 11 B.T.A. 1425 (1928), where the United States Board of Tax Appeals held that a company keeping its books on the accrual basis could claim depletion only on the number of pounds of copper sold during a taxable year, regardless of the number of pounds mined.

The language of section 1.613-3(a) of the regulations is intended to determine the amount of gross income from the property in computing the percentage depletion deduction but not the time for taking the depletion deduction.

The sale of the oil in the instant case is the event that, under section 1.446-1(c)(1)(ii) of the regulations, determines the year in which income is received. The movement of the oil off the premises does not give rise to a depletion deduction; the oil must be sold before depletion can be claimed. The timing of the depletion deduction is not determined by transporting the oil from the premises but by the sale of the oil.

Accordingly, in the instant case the taxpayer must take into account a deduction for depletion in the year the oil was sold rather than in the year in which it was produced and moved from the premises.

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26 CFR 1.613-4: Gross income from the property in the case of minerals other than oil and gas.

Depletion; granite and marble byproducts. Amounts received from the incidental production and sale

of crushed granite and marble as a byproduct of the extraction of rough quarry blocks are includible in gross income subject to percentage depletion. The costs incurred to produce these byproducts are mining costs. When the proportionate profits method is used to determine gross income from mining for the rough quarry blocks, the income attributable to the sale of crushed granite or marble produced as a byproduct incident to operations subsequent to mining processes is includible in the overall profits to be allocated to mining and nonmining activities. The costs incurred to produce crushed granite or marble as a byproduct of the nonmining processes are not mining costs in the proportionate profits method. Rev. Rul. 55-390 superseded.

Rev. Rul. 76-389

Advice has been requested as to the proper method of computing gross income from mining for purposes of the percentage depletion allowance in the case of granite and marble, under the circumstances described below.

The taxpayer owns and operates quarries with the main objective of producing granite and marble quarry blocks. There is no representative market or field price for granite or marble quarry blocks. After extraction from the ground the granite and marble blocks are shipped by rail to the taxpayer's processing plant where the granite or marble quarry blocks are sawed, shaped, polished, and further processed into specific pieces according to the purchaser's specifications. Crushed granite and marble is produced from waste at the quarries as a byproduct of the quarry operations and at the processing plant as a byproduct of the taxpayer's coping, sawing cutting, shaping, and polishing operations.

Section 613(c)(5) of the Internal Revenue Code of 1954 provides, in part, that polishing and shaping are treatment processes not considered as mining.

Section 1.613-4(f)(5) of the Income Tax Regulations provides, in part, that crushing is recognized as an allowable mining process. However, section 1.613-4(g)(2) provides, in part, that notwithstanding any other provisions of section 1.613-4, a process applied subsequent to a nonmining process (other than nonmining transportation) shall also be considered to be a nonmining process.

Section 1.613-4(d)(1)(i) of the regulations provides, in part, that if it is impossible to determine a representative market or field price, gross income from mining shall be computed by use of the proportionate profits method set forth in section 1.613-4(d)(4). Section 1.613-4(d)(4)(ii) provides that the proportionate profits method is applied by multiplying the taxpayer's gross sales (actual or constructive) of its first marketable product or group of products by a fraction whose numerator is the sum of all of the costs allocated to those mining processes that are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products.

Under the provisions of section 1.613-5(a) of the regulations taxable income from the property means gross income from the property less all allowable deductions (computed without allowance for depletion) that are attributable to mining processes, including mining transportation, with respect to which depletion is claimed.

Accordingly, where the main objective of mining granite or marble is the production of rough quarry blocks, the mining processes end when the rough quarry blocks of granite or marble are removed to the rim of the quarry and before they are shipped or transferred to a processing plant for sawing, shaping, and polishing. See: *Gray Knox Marble Co. v. United States,* 257 F. Supp. 632 (E.D. Tenn. 1966), where the court held that mining ceases when the rough quarry blocks are brought to the rim of the quarry. If the taxpayer incidentally produces crushed granite or marble as a byproduct of the extraction process at the mine or quarry, crushing of such granite or marble is considered to be a mining process and amounts received for such crushed granite or marble are to be included in gross income subject to percentage depletion. When because of subsequent nonmining operations, it is necessary to compute gross income from mining for the granite or marble quarry blocks by the proportionate profits method under the provisions of section 1.613-4(d) of the regulations, any income from crushed granite or marble byproduct incident to operations subsequent to mining is includible in determining the overall profits to be allocated to mining and nonmining activities for percentage depletion purposes. However, the costs incurred to produce crushed granite or marble as a byproduct of the processing plant are not mining costs in the proportionate profits computation since that crushing follows nonmining processes and is a nonmining process.

Rev. Rul. 55-390, 1955-1 C.B. 290, which deals with a similar factual situation, is amplified and, as amplified, is superseded, since the position is restated under current law in this Revenue Ruling.

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26 CFR 1.613-4: Gross income from the property in the case of minerals other than oil and gas.

Depletion; bentonite; drying processes. The process of drying bentonite at temperatures that remove all the pore water and 90 to 94 percent of the interlayered water from the mineral, but that does not change its physical or chemical identity, is an ordinary treatment process considered as mining under

section 613(c)(4)(I) of the Code. However, the process required to expel the water of crystallization from the bentonite at temperatures that alter the mineral both physically and chemically is not a treatment process considered as mining.

Rev. Rul. 76-444

Advice has been requested whether, under the circumstances described below, the process of drying bentonite is an ordinary treatment process considered as "mining" under section 613 (c)(4)(I) of the Internal Revenue Code of 1954.

A taxpayer mines and processes a swelling montmorillonite clay mineral (bentonite), which has a moisture content of 30 to 40 percent and is used or sold for use, after processing, for a number of industrial uses. Some of these uses are as a binder in foundry sand, a binder in iron ore pelletizing, a drilling mud additive, an absorbent, or as a filtering and clarifying medium.

In this Revenue Ruling the term "bentonite" refers to montmorillonite clay minerals that are usually highly colloidal, plastic, and capable of expanding to several times their original volume when mixed with water to form thixotropic gels. Montmorillonite clay minerals are arranged in a structure of parallel plate-like layers. Montmorillonite clay minerals may have associated with them three types of water: (1) Pore water—water in pores, on the surface, and around the edges of discrete particles of montmorillonite mineral; (2) Interlayered water—water between the plate-like layers of montmorillonite mineral; and (3) Water of crystallization—water that is chemically combined as a part of the montmorillonite mineral. Pore water and interlayered water are free water as compared to the water of crystallization, which is combined water.

In addition to extraction of the mineral from the ground the treatment processes applied to the bentonite prior to shipment consist of primary crushing, secondary crushing, drying, sizing, and loading for shipment. The drying in question is performed in rotary dryers. One portion of the bentonite is processed through a dryer with a discharge temperature of approximately 300 degree Fahrenheit (149 degrees Celsius) for the purpose of removing all of the pore water and 90 to 94 percent of the interlayered water that is not chemically combined with the crude material. The remaining bentonite is processed through a dryer with a discharge temperature of approximately 1112 degrees Fahrenheit (600 degrees Celsius) for the purpose of removing 100 percent of the water, including the water of crystallization that is chemically combined with the crude mineral. The bentonite is sold or used after the listed processes are applied.

The two types of free water that can be held by montmorillonite, namely pore water and interlayered water, are expelled from the mineral by heating at relatively low temperatures. Pore water generally requires very little heat for removal. Therefore, drying at temperatures slightly above ordinary room temperatures generally is adequate for its complete removal. Interlayered water requires considerably more heat for its removal. Temperatures from about 212 degrees to 396 degrees Fahrenheit (100 degrees to 202 degrees Celsius) are required for partial removal of interlayered water. It is essential in this regard that the drying process be carefully controlled to assure that some of the interlayered water remains between the plate-like layers of the clay. If all of the interlayered water is removed, the plate-like layers collapse so that it is virtually impossible for water to reenter, thereby changing the natural physical properties of the bentonite. The removal of the physically combined pore water and 90 to 94 percent of the interlayered water does not change the physical or chemical identity of the taxpayer's bentonite so long as a portion of the interlayered water is retained.

For the removal of the water of crystallization, a much higher temperature is required because it is necessary to dissociate chemically the montmorillonite mineral into water and other compounds. Extensive heating from about 742 degrees to 1112 degrees Fahrenheit (394 degrees to 600 degrees Celsius) is required to expel the water of crystallization and such heating results in a physical as well as a chemical change in the montmorillonite mineral.

Bentonite is identified as a separate mineral in section 613(b)(3)(B) of the Code. That section specifies a percentage depletion rate of 14 percent for bentonite. Bentonite comes within the provisions of section 613 (c)(4)(C) of the Code and section 1.613-4(f)(3)(iv) of the Income Tax Regulations as a mineral customarily sold in the crude mineral form because a significant portion of bentonite is sold or used before alteration of its inherent mineral content.

Section 613(c)(2) of the Code defines mining as including not merely the extraction of the ores or minerals from the ground but also the "treatment processes considered as mining" described in section 613(c)(4). Section 613(c)(4)(C) includes, as "treatment processes considered as mining" for minerals that are customarily sold in the form of a crude mineral product, the processes of "sorting, concentrating, sintering, and substantially equivalent processes to bring to shipping grade and form, and loading for shipment." Section 613 (c)(4)(I) provides that any other treatment process provided for by regulations prescribed by the Secretary or the Secretary's delegate, which (with respect to the particular ore or mineral) is not inconsistent with the other provisions of the statute regarding classification of a process, will also

be a treatment process considered as mining.

Section 1.613-4(f)(5)(iii) of the regulations provides that under the authority granted the Secretary the process of drying to remove free water, provided that such drying does not change the physical or chemical identitly or composition of the mineral, is a process recognized as mining.

Since the first drying process discussed above does not remove all of the interlayered water, this process does not change the physical or chemical identity of the bentonite within the meaning of section 1.613-4(f)(5)(iii) of the regulations. The second drying process removes the water of crystallization at temperatures which dissociate the montmorillonite mineral into water and other compounds and changes the physical or chemical identity of the bentonite within the meaning of section 1.613-4(f)(5)(iii).

Accordingly, the drying of bentonite at temperatures of approximately 300 degrees Fahrenheit (149 degrees Celsius) that removes pore water and 90 to 94 percent of the interlayered water is a treatment process considered as mining for purposes of section 613(c)(4)(I) of the Code and section 1.613-4(f)(5)(iii) of the regulations. On the other hand, the removal of water of crystallization at temperatures that alter the mineral both physically and chemically is not a treatment process considered as mining for purposes of section 1.613-4(f)(5)(iii) and is not, therefore, a mining process.

Subchapter J.—Estates, Trusts, Beneficiaries and Decedents
Part I.—Estates, Trusts, and Beneficiaries
Subpart A.—General Rules for Taxation of Estates and Trusts

Section 641.—Imposition of Tax

26 CFR 1.641(a)-O: Scope of subchapter J.
(Also Sections 651, 661; 1.651(a)-2, 1.661(a)-2.)

Trust for care of pet animal. In the absence of a state law to the contrary, a bequest in trust to provide for the care of a decedent's pet animal is void from its inception, and unless otherwise indicated in the will or specified by statute, the trust property passes to the residuary legatee and income earned on such property is includible in the income of such legatee. In jurisdictions where such a trust is not invalid, it is subject to the imposition of the tax of section 1(d) of the Code pursuant to section 641 and no deductions are allowable for distributions under sections 651 and 661.

Rev. Rul. 76-486

Advice has been requested whether, under the circumstances described below, a bequest in trust for the care of a pet animal creates a valid trust for purposes of the imposition of tax under section 641 of the Internal Revenue Code of 1954.

A, a resident of State *X*, died testate in 1976. Under the terms of *A*'s will *A*'s entire property passed to designated individuals, including a residuary legatee, with the exception of a fund that was established to care for *A*'s pet animal. The income of the fund, to the extent required, is to be used for the care of the animal. Upon the death of the animal, the corpus of the fund is to be distributed to *A*'s heirs, if living, or their descendants.

Under the common law rule against perpetuities, the period during which vesting of interests in property may be postponed is limited to a life or lives in being plus twenty-one years and any period of gestation involved in the situation to which the limitation applies. It has generally been assumed that the lives that measure the period of perpetuities should be human lives. *II Scott on Trusts*, section 124.3 (3d ed. 1967); *Restatement of Property*, section 374, comment h (1944).

In the absence of statutory abrogation, the rule against perpetuities is part of the common law in most jurisdictions in the United States. State *X* has adopted no statute that would render the rule against perpetuities inapplicable in the circumstances set forth in the instant case. Since the life of an animal is not a proper measuring life in being under the rule against perpetuities in State *X*, the bequest in trust to provide for the care of the animal was void from its inception.

The law of State *X* provides that personal property comprising any bequest that fails, is void, or is otherwise incapable of taking effect, will be included in the residuary bequest, if any, contained in the decedent's will, unless a contrary intention appears in the will.

Accordingly, in the instant case, since the bequest in trust for the care of the pet animal was void from its inception, a valid trust never came into being for purposes of the imposition of tax under section 641 of the Code. Further, the property passed to the residuary legatee pursuant to the law of State *X*, because no contrary intention appears in the will, and the income earned on such property is includible in the income of the residuary legatee in the year the income is received.

A bequest in trust for the care of a pet animal is not void from its inception in all states. In those jurisdictions where a trust created by such a bequest is valid, the trust is unenforceable because there is no one who as beneficiary can compel the trustee to carry out the purpose of the testator. Such intended trusts have been characterized as "honorary trusts," the conscience of the trustee being the only compelling influence on performance. However should the trustee fail to perform the intention of the testator, the trustee will not be allowed to keep the property; instead a resulting trust will arise in favor of the testator's residuary legatees. See *Scott on Trusts*, sections 123(2) and 124 (3d ed. 1967). The income tax consequences of an honor-

ary trust will depend on whether it will qualify as a valid trust for purposes of section 641 of the Code.

Section 641 of the Code provides, in part, that the taxable income of a trust is computed in the same manner as in the case of an individual, except as otherwise provided. Also, a trust is generally allowed, in computing its taxable income, the deduction provided by either section 651 or section 661 and the regulations thereunder, relating to distributions to beneficiaries.

Section 651 of the Code provides for a deduction in the case of a trust that distributes current income only. The deduction is limited to the amount of the distributable net income regardless of whether the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year. Section 652 provides, in part, that the amount of income for the taxable year required to be distributed currently by a trust shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not. Such includible amount shall be an amount equal to each beneficiary's share of distributable net income of the trust.

Section 661 of the Code allows a deduction to a trust not qualifying under the provisions of section 651 in computing its taxable income, for any amount of its income for such taxable year required to be distributed currently and any other amount properly paid or credited or required to be distributed to a beneficiary for the taxable year to the extent such deduction does not exceed the distributable net income of the trust. Section 662 provides generally that the beneficiary of a trust must include in gross income all amounts that are deductible by the trust under section 661(a).

Section 301.7701-4(a) of the Income Tax Regulations provides that in general, the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate court.

The term "beneficiary," for purposes of Part I, subchapter J, of the Code, is defined in section 643(c) to include heirs, legatees, and devisees. Heirs, legatees, and devisees are persons. See 96 C.J.S. *Wills*, section 1097 (1957). For purposes of the Code, where not otherwise distinctly expressed to the contrary or manifestly incompatible with the intent thereof, the term "person" is construed to mean and include an individual, trust, estate, partnership, association, company or corporation. Section 7701(a). Since animals do not fall within this category, they cannot be beneficiaries for purposes of section 643(c).

Since a beneficiary is lacking, a bequest in trust for a pet animal does not fit into the traditional concept of a trust, as set out in section 301.7701 of the regulations. Such an arrangement, however, should nonetheless be classified as a trust for tax purposes under section 641 of the Code in those jurisdictions where it would not be invalid. To treat this arrangement as not being a taxable trust would, in addition to ignoring its validity under local law, cause the income on the bequest to escape taxation altogether, since the distributions of income for the benefit of the pet animal would similarly not be taxed.

Accordingly, the taxable income of a fund, which is not invalid under state law, bequeathed in trust for the benefit of an animal, is subject to the imposition of the tax of section 1(d) of the Code pursuant to section 641. See Rev. Rul. 58-190, 1958-1 C.B. 15, which holds that a trust is created for purposes of section 641 where funds are received by a cemetery company or corporation for the perpetual care of an individual lot or mausoleum crypt.

Furthermore, since the amounts of income required to be distributed under section 651 of the Code and amounts properly paid, credited, or required to be distributed under section 661 are limited to distributions intended for beneficiaries, a deduction under those sections is not available for distributions for the benefit of a pet animal. Similarly, such distributions are not taxed to anyone under sections 652 and 662.

Section 642.—Special Rules for Credits and Deductions

26 CFR 1.642(c)-5: Definition of pooled income fund.

Pooled income fund; income interest not represented by units of participation. A fund established by a charitable organization to be used exclusively for the investment of properties in which it has remainder interests, whose governing instrument requires that income accumulated during the period of administration of a donor's estate and payable to the fund under state law be paid to the life income beneficiary without being included in determining the beneficiary's units of participation in the fund, will not qualify as a pooled income fund.

Rev. Rul. 76-445

Advice has been requested whether the fund described below qualifies as a pooled income fund under the provisions of section 642(c)(5) of the Internal Revenue Code of 1954.

A charitable organization, as described in section 170(b)(1)(A) of the Code (other than in clauses (vii) and (viii)), established the fund to be used exclusively for the investment of properties in which it had acquired remainder interests by contributions from donors.

The governing instrument of the fund provides, in part, that in the case

where a transfer to the fund is directed by will or other instrument to be effective upon death of the donor, and such transfer includes income accumulated during the period of administration of the estate of the donor and payable to the fund under the governing state law, such income shall be income payable by the fund to the beneficiary of the life income interest created by the donor. Such income shall not be included in the valuation of assets delivered to the trustee for purposes of determining the number of units of participation of the fund to be allocated to the beneficiary designated by the donor.

In all other respects the provisions of the fund's declaration of trust and instrument of transfer meet the requirements of a pooled income fund as defined in section 642(c)(5) of the Code.

Section 642(c)(5) of the Code defines a pooled income fund and section 1.642(c)-5(b) of the Income Tax Regulations sets forth all the requirements that must be satisfied for qualification as a pooled income fund.

Under section 642(c)(5)(B) of the Code and section 1.642(c)-5(b)(3) of the regulations, property transferred to the fund by each donor must be commingled with, and invested or reinvested with, other property transferred to the fund by other donors. The fund must not include property transferred under arrangements other than those specified in section 642(c)(5) and section 1.642(c)-5(b).

Under section 1.642(c)-5(b)(7) of the regulations, each beneficiary entitled to income of any taxable year of the fund must receive such income in an amount determined by the rate of return earned by the fund for such taxable year with respect to the beneficiary's interest, computed as provided in section 1.642(c)-5(c).

Section 1.642(c)-5(c) of the regulations provides, in part, that every income interest retained or created in property transferred to a pooled income fund shall be assigned a proportionate share of the annual income earned by the fund, such share, or unit of participation, being based on the fair market value of such property on the date of transfer to the fund.

In the instant case, the property is not transferred to the fund in accordance with the provisions of section 642(c)(5)(B) of the Code since the income accumulated during the period of administration of the estate of the donor is transferred to the fund specifically for payment to the beneficiary of the life income interest created by the donor, and payment of such amount is other than as specified in section 1.642(c)-5(b)(7) of the regulations.

Accordingly, the described fund does not qualify as a pooled income fund pursuant to section 642(c)(5) of the Code.

This fund is distinguishable from one in which the governing instrument provides that the estate may retain the income from the transferred property that has accumulated during a reasonable period of estate administration, and pay such income to the life income beneficiary, whenever permitted by state law and the donor's will (or other governing instrument). Such a provision would not prevent the fund from qualifying as a pooled income fund.

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26 CFR 1.642(g)-2: Deductions included.

Treatment of trustees' fees paid by an estate to trustees of a grantor trust. See Rev. Rul. 76-498, page 199.

Subpart B.—Trusts Which Distribute Current Income Only

Section 651.—Deduction for Trusts Distributing Current Income Only

26 CFR 1.651(a)-2: Income required to be distributed currently.

Treatment of distributions pursuant to a valid trust. See Rev. Rul. 76-486, page 192.

Subpart C.—Estates and Trusts Which May Accumulate Income or Which Distribute Corpus

Section 661.—Deduction for Estates and Trusts Accumulating Income or Distributing Corpus

26 CFR 1.661(a)-2: Deduction for distributions to beneficiaries.

Treatment of distributions pursuant to a valid trust. See Rev. Rul. 76-486, page 192.

Section 664.—Charitable Remainder Trusts

26 CFR 1.664-1: Charitable remainder trusts.

Charitable remainder trust; distributions to second trust. An otherwise qualifying charitable remainder trust that makes distributions to a second trust whose only function is to receive and administer those distributions for the benefit of the named individual lifetime beneficiary of the charitable remainder trust is considered to have made the distributions directly to the individual and qualifies as a charitable remainder trust.

Rev. Rul. 76-270

Advice has been requested whether, under the circumstances described below, a trust qualifies as a charitable remainder trust under section 664 of the Internal Revenue Code of 1954 and the applicable regulations.

An individual concurrently created trust *A*, and a separate trust, trust *B*. Under the governing instrument of trust *A*, a trust that otherwise qualifies as a charitable remainder trust, the specified distribution is to be made to trust *B* for the benefit of *C*, an incompetent, who is the individual named as the lifetime beneficiary of trust *A*. The governing instrument of trust *B* provides that the income of the trust will be used exclusively for the benefit of *C* and that upon the death of *C* the trust will terminate.

The governing instrument of trust *B*

further provides for payment to *C* each month of a designated portion of the amount it receives from trust *A* and if at any time, in the sole judgement of the trustee, the monthly payment to *C* is insufficient to provide adequately for the care, support, and maintenance of *C*, or is insufficient for the needs of *C* for any reason, additional amounts will be paid as needed to or on behalf of *C* from trust *B*. The instrument further provides that any amounts remaining in trust *B* at *C*'s death will be distributed to *C*'s estate.

The specific question presented is whether trust *A* would be disqualified as a charitable remainder trust because it makes the specified distribution to trust *B* for the benefit of *C* rather than making such distribution directly to *C*.

Section 1.664-1(a)(1) of the Income Tax Regulations provides the general rule that a charitable remainder trust is a trust that provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity.

Section 1.664-1(a)(2) of the regulations provides that a trust is a charitable remainder trust only if it is either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect.

Sections 1.664-2(a)(3) and 1.664-3(a)(3) of the regulations provide, with regard to charitable remainder annuity trusts and charitable remainder unitrusts, respectively, that distributions must be payable to or for the use of a named person or persons. However, sections 1.664-2(a)(5) and 1.664-3(a)(5) provide that only an individual or an organization described in section 170(c) of the Code may receive an amount for the life of an individual.

Since the only function of trust *B* is to receive and administer the payments it receives from trust *A* for the benefit of *C*, an incompetent who is the named individual lifetime beneficiary of trust *A*, *C* is considered to have received the specified distribution directly from trust *A*.

Accordingly, in the instant case, although the form of the income payments is from trust *A* to trust *B* to individual *C* for the life of *C*, the payment of the specified distribution to trust *B* will not disqualify trust *A* as a charitable remainder trust under section 664 of the Code and the applicable regulations.

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26 CFR 1.664-1: Charitable remainder trusts.

Charitable remainder trust; qualification. The governing instrument of an otherwise qualifying charitable remainder trust, providing for designated payments to two beneficiaries and the balance of the specified distribution to a third beneficiary with any deceased beneficiary's share to be retained by the trust until its distribution to the remainderman, makes it possible for the designated annual payments to fail to meet the requirements for a charitable remainder annuity trust or a charitable remainder unitrust and the trust fails to qualify as a charitable remainder trust.

Rev. Rul. 76-280

Advice has been requested whether, under the circumstances described below, a trust qualifies as a charitable remainder trust under the provisions of section 664 of the Internal Revenue Code of 1954 and the applicable regulations.

The governing instrument of the trust, which otherwise qualifies as a charitable remainder trust, provides that the annual payment of the specified distribution (a five percent annuity or unitrust amount, as the case may be) to the income beneficiaries will be as follows: *A* is to receive $25x$ dollars, *B* is to receive $15x$ dollars, and *C* is to receive the balance. Upon the death of any income beneficiary, the amount of income that the beneficiary would have been entitled to receive will be retained by the trust until the death of the last income beneficiary. Upon the death of the last income beneficiary, the assets of the trust are to be distributed to the remainderman in accordance with the provisions of the trust.

Section 1.664-1(a)(2) of the Income Tax Regulations provides that a trust is a charitable remainder trust only if it is either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect.

Section 1.664-1(a)(1) of the regulations provides the general rule that a charitable remainder trust is a trust that provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity. The specified distribution to be paid at least annually must be a sum certain that is not less than five percent of the initial net fair market value of all property placed in trust, in the case of a charitable remainder annuity trust, or a fixed percentage that is not less than five percent of the net fair market value of the trust assets, valued annually, in the case of a charitable remainder unitrust.

Under section 1.664-1(a)(1)(iii) of the regulations, the term "annuity amount" means the sum certain that is payable, at least annually, to the beneficiary of a charitable remainder annuity trust. The term "unitrust amount" means the fixed percentage that is payable, at least annually, to the beneficiary of a charitable remainder unitrust.

If *C* dies before either *A* or *B*, the total of the designated amounts payable annually will be less than the annuity amount that must be paid out annually, in the case of a charitable

remainder annuity trust, or it is possible that the total of the designated amounts payable annually will be different from the unitrust amount that must be paid out annually, in the case of a charitable remainder unitrust. Further, even if *C* does not die before *A* or *B*, the designated amounts payable annually may exceed the unitrust amount in the case of a charitable remainder unitrust. For example, if in a given taxable year five percent of the net fair market value of the trust assets on the valuation date equals an amount that is less than 40*x* dollars, the designated amounts payable to *A* and *B* would exceed the unitrust amount for that taxable year.

Accordingly, in the instant case, the trust will not qualify as a charitable remainder trust under section 664 of the Code and the applicable regulations.

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26 CFR 1.664-1: Charitable remainder trusts.
(Also Section 170; 1.170A-1.)

Charitable remainder annuity trust; qualification. The contingent provision in a trust instrument, providing that all the trust assets revert to the grantors in the event the Service disallows a charitable deduction for the value of the remainder interest, precludes the trust from meeting the definition of a charitable remainder annuity trust and the value of the remainder interest contributed to the trust is not deductible as a charitable contribution; Rev. Rul. 60-276 distinguished.

Rev. Rul. 76-309

Advice has been requested whether, under the circumstances described below, a trust qualifies as a charitable remainder annuity trust under section 644 of the Internal Revenue Code of 1954.

The grantors contributed property to a trust and claimed a charitable contribution deduction under section 170 of the Code for the value of the remainder interest. The governing instrument of the trust was intended to comply with the provisions of section 664 and the regulations thereunder. Under the terms of the instrument the trust shall be deemed null and void and all the trust assets returned to the grantors if the Internal Revenue Service disallows a deduction for the value of the remainder interest.

A charitable remainder annuity trust is defined in section 664(d)(1) of the Code. Section 664(d)(1)(A) provides that a charitable remainder annuity trust is a trust from which a sum certain (which is not less than 5 percent of all property placed in trust) is to be paid, not less often than annually to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals.

Section 664(d)(1)(B) of the Code provides that no amount of a charitable remainder annuity trust other than the annuity payments described in subparagraph (A) may be paid to or for the use of any person other than an organization described in section 170(c).

Section 664(d)(1)(C) of the Code provides that following the termination of the annuity payments described in subparagraph (A), the remainder interest in the charitable remainder annuity trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use.

Under section 1.664-2(a)(4) of the Income Tax Regulations, no amount other than the annuity amount described in section 1.664-2(a)(1) of the regulations may be paid to or for the use of any person other than an organization described in section 170(c) of the Code.

Under section 1.664-2(a)(6)(i) of the regulations, the entire corpus of the charitable remainder annuity trust is required to be transferred to or for the use of one or more organizations described in section 170(c) of the Code or retained for such use upon the termination of all noncharitable interests.

In the instant case the condition in the trust instrument providing for the trust assets to be returned to the grantors if the Service disallows a deduction for the remainder interest presents the possibility that amounts other than the annuity payments will be paid to a person other than an organization described in section 170(c) of the Code and that the remainder interest will not be transferred to or for the use of a charitable organization or retained by the trust for such a use.

Accordingly, the trust does not qualify as a charitable remainder annuity trust under section 664 of the Code and the value of the remainder interest contributed to the trust is not deductible as a charitable contribution for Federal income tax purposes.

The instant case is distinguishable from the case in which the trust assets may be returned to the grantor only if the Internal Revenue Service refuses to rule that the trust is initially qualified under section 664 of the Code. See, for example, Rev. Rul. 60-276, 1960-2 C.B. 150. In the latter case, there is no condition that can occur upon which the trust assets may be returned to the grantor after the Service has ruled that the trust is initially qualified.

Rev. Rul. 60-276 distinguished.

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26 CFR 1.664-1: Charitable remainder trusts.

Qualification for treatment as a charitable remainder trust where unitrust amount is payable until remarriage or death of beneficiary. See Rev. Rul. 76-291, page 284.

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26 CFR 1.664-1: Charitable remainder trusts.

Whether deductions for charitable contributions for property transferred to a

charitable remainder trust are allowable. See Rev. Rul. 76-307, page 56.

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26 CFR 1.664-3: Charitable remainder unitrust.

Charitable remainder unitrust; assets divided and separately maintained. A provision of the governing instrument of an otherwise qualifying charitable remainder unitrust that provides for the trust assets to be divided into two equal and separately administered parts for the benefit of the designated life beneficiary of each part makes it possible for the total payments in a taxable year to be less than the total aggregate trust income required to be distributed by the trustee under section 664(d)(3) of the Code and thereby precludes the trust from qualifying as a charitable remainder unitrust.

Rev. Rul. 76-310

Advice has been requested whether a trust, as described below, qualifies as a charitable remainder unitrust under section 664 of the Internal Revenue Code of 1954 and the regulations thereunder.

The governing instrument of the trust, otherwise qualifying as a charitable remainder unitrust, provides that the trustee is to pay the grantor, during the grantor's lifetime, the lesser of five percent of the net fair market value of the trust assets valued annually or the trust income for such year. In the event that trust income exceeds five percent of the net fair market value of the trust assets during a taxable year, the trustee is to distribute to the grantor the excess of such income to the extent of the aggregate of deficiencies in prior years when income fell below five percent.

Upon the death of the grantor, the trustee is to make the payments to the grantor's spouse for the spouse's lifetime, should the spouse survive the grantor.

The trust instrument provides that upon the death of the grantor's spouse, or upon the grantor's death, if the grantor's spouse predeceases the grantor, the trustee must divide the then remaining trust assets into two equal parts. Each part is to be operated separately for the respective benefit of *A* and *B*, the children of the grantor.

The trustee is to pay to *A* the lesser of five percent of the net fair market value of one equal part of the total trust assets valued annually or the annual income of this equal part. Upon the death of *A*, the trustee must make the payments to *B*.

The trustee is to pay to *B* the lesser of five percent of the net fair market value of the other equal part of the total trust assets valued annually or the annual income of this equal part. Upon the death of *B*, the trustee must make the payments to *A*.

The governing instrument further provides that upon the death of the survivor of the grantor, the grantor's spouse, *A*, and *B*, the trust assets are to be distributed to designated organizations of the type described in section 170(c) of the Code.

Under section 664(d)(2)(A) of the Code, in order to qualify as a charitable remainder unitrust, a trust must pay at least annually a fixed percentage (which is not less than five percent) of the net fair market value of its assets to one or more persons other than an organization described in section 170(c), subject to specified conditions as to the duration of such payments. Under an exception to the foregoing rule, provided by section 664(d)(3) and section 1.664-3(a)(1)(i)(*b*)(1) of the Income Tax Regulations, a trust instrument may provide that the trustee shall pay the income beneficiary for any year the amount of the trust income if such amount is less than the fixed percentage of the trust assets, and any amount of the trust income in excess of such fixed percentage to the extent that the amounts paid in prior years were less than the fixed percentage.

The reason for the foregoing requirements as to the minimum amounts of the annual payments is set forth in the Senate Finance Committee Report on section 664 of the Code. This Report states that requiring a charitable remainder trust to distribute currently at least the amount of its income or five percent of the value of its assets together with the requirement that the charitable remainder interest be valued by assuming at least a five percent payout to the income beneficiary. will prevent a charitable remainder trust from being used to circumvent the current income distribution requirements imposed on private foundations. In the absence of these rules, a charitable remainder trust could be established with a minimal payout to the income beneficiary, thereby allowing trust income to be accumulated without tax for the future benefit of the charity. *S. Rep. No. 91-952* 91st Cong., 1st Sess. 90 (1969), 1969-3 C.B. 423, 481.

In the present case, the division of the trust assets into two equal parts and the provisions of the trust instrument directing the separate operation of these parts may cause the trustee, in some taxable years, not to distribute the amounts required to be paid from the entire trust under section 664(d)(3) of the Code and section 1.664-3(a)(1)(i)(*b*)(1) of the regulations. For example, in some taxable years of the trust, it is possible that one part of the total trust assets will earn little or no income while the other part of the total trust assets will earn income exceeding five percent of the net fair market value of its assets. Thus, under the income exception form of payment and in accordance with the provisions of the trust instrument that directs the separate operation of the two equal parts, the total payments in some taxable years, which consist of the trust income of one part limited by the amount of income earned plus the trust income of the other part limited by the amount that is not more than

the designated fixed percentage of the net fair market value of that part's assets, could be less than the total of all trust income earned by the entire trust assets and required to be distributed by the trustee under section 664 (d) (3) and section 1.664-3(a) (1) (i) (*b*) (1).

Accordingly, the trust does not meet the requirements of section 664 of the Code and the applicable regulations, and does not qualify as a charitable remainder unitrust.

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26 CFR 1.664-3: Charitable remainder unitrust. .

Charitable remainder unitrust; valuation; unitrust payment prior to annual valuation. An acceptable method is set forth for determining the net fair market value of the assets of a charitable remainder unitrust from which payments are made to the income beneficiary prior to the annual valuation date.

Rev. Rul. 76-467

Advice has been requested as to what assets and liabilities are taken into account, under the circumstances described below, in computing the net fair market value of the assets of a charitable remainder unitrust qualifying under section 664 of the Internal Revenue Code of 1954 where there have been payments to the income beneficiary in advance of the annual valuation date.

The governing instrument of the trust provides that the unitrust amount, equal to six percent of the net fair market value of the trust's assets, is to be paid to the income beneficiary in quarterly installments during each taxable year of the trust. The instrument further provides that computation of the net fair market value of the trust's assets shall be made as of the last day of each taxable year of the trust, and shall take into account all assets and liabilities of the trust without regard to whether particular items are taken into account in determining the income of the trust. The foregoing provisions comply with the requirements of section 1.664-3(a) (1) (i) (a) of the Income Tax Regulations that the governing instrument of a charitable remainder unitrust must provide that the trust shall pay, not less often than annually, a fixed percentage of the net fair market value of the trust's assets, determined annually, to one or more persons described in section 1.664-3(a) (3) of the regulations for the period specified in section 1.664-3 (a) (5).

Section 1.664-3(a) (1) (iv) of the regulations, regarding rules applicable to the valuation of a charitable remainder unitrust, states, in part, that in computing the net fair market value of the trust assets there shall be taken into account all assets and liabilities without regard to whether particular items are taken into account in determining the income of the trust. The net fair market value of the trust assets may be determined on any one date or by taking the average of valuations made on more than one date during the taxable year of the trust. The amount that must be paid each year must be based upon the valuation for such year.

Section 1.664-3(a) (1) (v) of the regulations concerns computations of the unitrust amount in special circumstances such as a short taxable year, or the last taxable year of the trust. However, it does not discuss the method of computing the net fair market value of the trust assets. It states only that such valuation must be used as the basis for computing the unitrust amount. Also, section 1.664-3(a) (1) (iii) considers incorrect valuations and the proper way to adjust incorrect valuations; it does not discuss the method of computing the net fair market value of the trust's assets for purposes of determining the correct unitrust amount.

Under section 1.664-3(a) (1) (iv) of the regulations, all assets and liabilities must be taken into consideration, and thus such assets and liabilities must be considered without alteration, reduction, increase or modifications as of the annual valuation date, unless specifically authorized otherwise by the Code or the regulations.

Various methods of computing the unitrust amount have been considered in situations where the governing instrument of a charitable remainder unitrust provides for an annual valuation date other than the first day of the trust's taxable year and where the trust further provides for payment of part or all of the unitrust amount prior to the annual valuation date.

An acceptable method of computation to be used where the annual valuation date is other than the first day of the taxable year of the trust, and where there has been one or more payments of the unitrust amount prior to such annual valuation date, should be a method that (1) can be consistently applied to all charitable remainder unitrusts without a first day of the taxable year annual valuation date, (2) is equitable to the income beneficiaries and the charitable remaindermen, and (3) limits the amount of distribution by providing a formula in accordance with which the trustee can uniformly determine the amount of the estimated unitrust payments to be made prior to the annual valuation date.

Accordingly, only the assets and liabilities in the trust on the annual valuation date are taken into account in computing the net fair market value of the assets upon which the unitrust amount is based. Any difference between the amounts paid prior to the annual valuation date and the unitrust amount finally determined will be treated as if it were a result of an incorrect valuation within the meaning of section 1.664-3(a) (1) (iii) of the regulations. In order to uniformly accomplish the computation of the unitrust amount, the trustee should annually make the following computation:

(a) For the purpose of determining the amount of payments to be made prior to the annual valuation date,

compute the net fair market value of the trust's assets on the first day of the trust's taxable year.

(b) Compute the estimated unitrust amount by multiplying the fixed percentage by the amount of the computation in (a) to obtain the amount to be paid to the recipient during the taxable year.

(c) Divide the figure computed in (b) by the appropriate number of payments to be made during the trust's taxable year. In the instant case, divide by four since the unitrust payment is to be made quarterly.

(d) Make the appropriate payments to the income beneficiary prior to the annual valuation date using the amounts derived in (c).

(e) On the annual valuation date, the actual unitrust amount payable is computed on the net fair market value of the assets then in the trust, including appreciation, but without adding back the prior payments made to the income beneficiary.

(f) The unitrust amount payable for the year, determined as in (e) above, is compared to the total of the actual payments made, as in (d) above. If the unitrust amount payable is in excess of the total of the actual payments made and there are one or more payments still to be made during the taxable year, the difference is to be paid in equal amounts over the remaining payments. If there are no additional payments to be made during the year and the unitrust amount payable is in excess of the total of the actual payments, or if there has been an overpayment, the difference should be considered as if it were a result of an incorrect valuation within the meaning of section 1.664-3(a)(1)(iii) of the regulations.

(g) If there is an amount due to any recipient at the end of the taxable year of the trust, as a result of an incorrect valuation in (f), that amount should be treated as if it were paid prior to computing the net fair market value of the trust's assets for purposes of determining the following year's estimated unitrust amount payments. The payment itself should be made in accordance with section 1.664-3(a)(1)(iii) of the regulations.

(h) If any recipient owes the trust for excess payments received, at the end of the taxable year of the trust, such excess amount should be added to the net fair market value of the trust's assets for the purpose of determining the following year's estimated unitrust amount. The payment of the amount owed by the recipient should be made in accordance with section 1.664-3(a)(1)(iii) of the regulations.

(i) No interest or growth factor should be used, and the provisions of (g) or (h), whichever is applicable, must be followed within a reasonable time after the final determination of the correct valuation. For purposes of the preceding sentence, a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 1041-B (including extensions) for such year. See section 1.664-3(a)(1)(i)(a) of the regulations.

Part II.—Income in Respect of Decedents

Section 691.—Recipients of Income in Respect of Decedents

26 CFR 1.691(b)-1: Allowance of deductions and credit in respect of decedents. (Also Sections 212, 642, 2053; 1.212-1, 1.642(g)-2, 20.2053-1, 20.2053-8.)

Commissions paid by decedent's estate to trustees of grantor trust. Statutory commissions and expenses paid by the estate of a decedent to the trustees of the decedent's grantor trust, consisting of income producing assets and certain real property not held for the production of income, are deductible for income tax and estate tax purposes to the extent that they are attributable to the income producing assets and represent a fee for services rendered through the date of the decedent's death. The statutory commissions and expenses allocable to services performed after the decedent's death, attributable to both the income producing assets and the real property, are deductible as administration expenses for estate tax purposes but are not deductible for income tax purposes.

Rev. Rul. 76-498

Advice has been requested whether, under the circumstances described below, statutory commissions paid by the estate of a decedent to the trustees of a grantor trust created by the decedent, are deductible under section 691(b) of the Internal Revenue Code of 1954, for income tax purposes, as well as under section 2053(a) for estate tax purposes.

In January 1970 the decedent, *A*, a resident of the State of New York, created a trust, the corpus of which consisted of income producing assets and certain real property not held for the production of income. Under the terms of the trust agreement, the trustees were directed to hold the properties of the trust, invest and reinvest the same, collect the income therefrom, and pay the entire net income, plus any principal as they might deem advisable, to or for the benefit of *A*. Upon *A*'s death, the trustees were directed to distribute the principal of the trust to such persons as *A* might direct or appoint by will or, in default of such appointment, to the legal representative of the decedent's estate. Thus, *A* was treated as the owner of the trust under section 677 of the Code, and under section 671 all items of income, deductions, and credits against tax of the trust were included in computing the taxable income and credits of *A* to the extent that such items would be taken into account in computing taxable income or credits against tax of an individual. *A* used the cash receipts and disbursements method of accounting.

A died on July 1, 1974, and exercised the power of appointment by will over the trust corpus, directing that

the income producing assets of the trust be paid to the executors of *A*'s estate and that the real property be conveyed absolutely to *A*'s children. In addition *A* directed that all *A*'s just debts be paid out of the estate.

After *A*'s death, the trustees of the trust liquidated the income producing assets of the trust, filed their final account under the applicable provisions of New York law, and thereafter delivered the corpus of the trust to the parties entitled to it under the will.

Under New York law, Civil Practice Law and Rules section 8005 (McKinney 1975), which refers to the Surrogate's Court Procedure Act section 2309 (McKinney 1967), the trustee of a trust is entitled to: (1) annual commissions at certain statutory rates; and (2) on the settlement of the trustee's account, reasonable and necessary expenses actually paid by the trustee, in addition to a commission from principal (at the rate of one percent) for paying out all sums of money that are principal. This statutory schedule of compensation, including the paying out commission, has been interpreted by New York courts as an effort to compensate trustees for the reasonable value of all services performed during the trust period, not merely the specific acts to which the statute refers. *See Matter of Roth,* 53 Misc. 2d 1066, 281 N.Y.S. 2d 225 (1967).

The estate paid all the annual commissions due, and all the expenses and paying out commissions due at the termination of the trust. The payment of such claims was allowable under New York law.

Section 691(b) of the Code provides that the amount of any deduction specified in section 212, in respect of a decedent, that is not properly allowable to the decedent for the taxable period in which falls the date of death, or a prior period, shall be allowed to the estate of the decedent in the taxable year when paid, or, if the estate of the decedent is not liable to discharge the obligation to which the deduction relates, the deduction shall be allowed to the person who by reason of the death of the decedent or by bequest, devise, or inheritance acquires, subject to such obligation, from the decedent an interest in property of the decedent.

Section 1.691(b)-1(a) of the Income Tax Regulations provides that the expenses described in section 212 of the Code that are deductible under section 691(b) are those for which the decedent was liable but which were not properly allowable as a deduction in the decedent's last taxable years or any prior taxable year.

Section 212 of the Code provides that in the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. Trustee's fees are deductible under section 212, if they are ordinary and necessary and paid during the taxable year. *See Trust of Bingham v. Commissioner,* 325 U.S. 365 (1945), 1945 C.B. 103.

Since *A* was treated as owner of the trust, *A* would have been treated as being liable for the commissions, if *A* had lived, to the extent that the commissions were for services rendered by the trustees prior to *A*'s death. If *A* had lived and paid the commissions and expenses *A* would have been allowed a deduction under section 212 of the Code for the commissions and expenses to the extent that they were attributable to the management of the income producing assets. Since the real property in the trust was not held for the production of income, the portion of the statutory commissions and expenses attributable to it would not have been deductible by *A*.

Accordingly, to the extent that the statutory commissions and expenses are attributable to the income producing assets of the trust and represent a fee for services rendered through July 1, 1974, the date of the decedent's death, the commissions and expenses paid by the estate to the trustee may be deducted under section 691(b) of the Code for income tax purposes. *See* Rev. Rul. 71-423, 1971-2 C.B. 255. The statutory commissions and expenses paid by the estate to the trustees for services rendered after *A*'s death on July 1, 1974, are not deductible under section 691(b). An allocation of the commissions between the period before and after death is therefore necessary. Commissions that represent compensation for the services made necessary by *A*'s death cannot be deducted under section 691(b). Such services include activities in terminating the trust and making a final distribution and accounting. Under New York law the trustees are entitled to the reasonable value of such services, limited by the statutory amount. *In re Barnett's Will,* 231 N.Y.S. 2d 471 (1962).

Section 642(g) of the Code and section 1.642(g)-2 of the regulations provide, in part, that amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction in computing the taxable income of the estate or any other person, but that this provision shall not apply with respect to deductions allowed under section 691.

Under section 2053(a)(3) of the Code, claims against the estate can be deducted from the gross estate to determine the taxable estate, to the extent that such claims are allowable by the laws of the jurisdiction under which the estate is being administered.

The portion of all the commissions and expenses that is allocable to services performed by the trustees prior to *A*'s death should be treated as a personal obligation of the decedent. Accordingly, the statutory commissions and expenses accrued prior to *A*'s death but paid by the estate are

deductible for estate tax purposes under section 2053(a)(3) of the Code as claims against the estate. Also, under section 642(g), the deduction of such commissions and expenses under section 691(b) for income tax purposes (to the extent attributable to the income producing assets) is not precluded by the same deduction under section 2053 for estate tax purposes. *See* Rev. Rul. 71-422, 1971-2 C.B. 255.

Under section 2053(a)(2) of the Code, administration expenses of the estate can be deducted from the gross estate in the same manner as claims against the estate. In addition, under section 2053(b), and section 20.2053-8 of the Estate and Gift Tax Regulations, amounts representing expenses incurred in administering property not subject to claims that is included in the gross estate can be deducted, in determining the taxable estate, to the same extent such amounts would be allowable as a deduction under subsection (a) if such property were subject to claims, and such amounts are paid before the expiration of the period of limitation for assessment provided in section 6501.

Since *A* directed that the income producing assets be turned over to the estate, those assets are property subject to claims, that is, property includible in the gross estate that, under applicable state law, would bear the burden of the payment of deductions in the final adjustment and settlement of the decedent's estate. See section 20.2053-1(c) of the regulations. However, although the value of the real property is includible in *A*'s estate under section 2036 of the Code, it is not subject to claims because title passes to the designated beneficiaries as remaindermen of the trust. *See In re Rolston's Estate,* 170 Misc. 548, 10 N.Y.S. 2d 660 (1939); and *Chase National Bank of City of New York v. Central Hanover Bank & Trust Co.,* 265 App. Div. 434, 39 N.Y.S. 2d 541 (1943).

Accordingly, the statutory commissions and expenses that are allocable to services performed by the trustees after *A*'s death and that were paid by the estate are deductible by the estate under section 2053 of the Code as administration expenses. The commissions and expenses attributable to the income producing assets turned over to the estate are deductible under section 2053(a)(2), and the commissions and expenses attributable to the real property are deductible under section 2053(b) and section 20.2053-8 of the regulations. *See* Rev. Rul. 69-402, 1969-2 C.B. 176. However, since such commissions and expenses of the estate attributable to the income producing assets and to the real property are not deductible under section 691(b), their deduction by the estate under section 2053 for estate tax purposes would preclude their deduction by the estate for income tax purposes. See section 642(g).

Section 692.—Income Taxes of Members of Armed Forces on Death

26 CFR 1.692-1: Abatement of income taxes of certain members of the Armed Forces of the United States upon death. (Also Sections 112, 7508.)

Armed Forces; combat zone death. Amounts withheld for income taxes in 1970 for a member of the Armed Services who first entered a combat zone in 1971, was reported missing in 1971, and presumed dead in 1974, is not subject to the provisions of section 692(a)(1) of the Code and thus the amounts withheld are refundable only to the extent of any overpayment. The amount of any tax liability in excess of the amount withheld will not be assessed under section 692(a)(2). FICA taxes deducted for years 1972 through 1974 will be refunded.

Rev. Rul. 76-355

Advice has been requested concerning the Federal income tax treatment of amounts withheld from the compensation of members of the Armed Forces pursuant to the provisions of section 692 of the Internal Revenue Code of 1954, under the circumstances described below.

A, a member of the Armed Forces, entered a combat zone, within the meaning of section 112 of the Code, during May 1971. In 1970, *A* had income of $30x$ dollars from which $4x$ dollars were withheld for income taxes and an appropriate amount for Federal Insurance Contribution Act (FICA) taxes. The due date of the 1970 Federal income tax return was before *A* entered the combat zone. *A* did not file any return or secure or request an extension of the filing date for 1970. *A* was reported missing during September 1971, and was presumed dead as of March 1974.

A Federal income tax return, filed on behalf of *A* in July 1974 for *A*'s 1970 taxable year, showed a tax liability of $5x$ dollars; however, the full amount of the withholding ($4x$ dollars) was claimed as the amount to be refunded since it was contended that because *A* had not filed a return for 1970 the tax on *A*'s 1970 income had not been assessed and, therefore, the entire amount withheld on *A*'s 1970 income should be refunded under section 692 of the Code.

B, a member of the Armed Forces, entered the combat zone during February 1971. *B* was reported missing during April 1971, and was presumed dead as of March 20, 1974. During 1974 a joint Federal income tax return was filed for *B* and *B*'s spouse for 1970 showing a tax liability of $12x$ dollars and withholding of $15x$ dollars for income taxes and an appropriate amount for FICA taxes. The return was timely filed under section 7508(a) of the Code which provides that a member of the Armed Forces serving in a combat zone may postpone filing a return.

The specific issues in the instant case are: (1) whether the entire amounts withheld from *A* and *B* for 1970 are refundable or whether only the over-

payment by *B* should be refunded, (2) whether the amount of the tax liability of *A* that is in excess of the amount withheld should not be assessed, and (3) whether amounts deducted for FICA taxes are refundable.

Section 692 of the Code, as amended by section 4 of Pub. L. 93-597, 93rd Cong., 2d Sess., (January 2, 1975), 1975-1 C.B. 495, provides as follows:

(a) General Rule.—In the case of any individual who dies while in active service as a member of the Armed Forces of the United States, if such death occurred while serving in a combat zone (as determined under section 112) or as a result of wounds, disease, or injury incurred while so serving—

(1) any tax imposed by this subtitle shall not apply with respect to the taxable year in which falls the date of his death, or with respect to any prior taxable year ending on or after the first day he so served in a combat zone after June 24, 1950; and

(2) any tax under this subtitle and under the corresponding provisions of prior revenue laws for taxable years preceding those specified in paragraph (1) which is unpaid at the date of his death (including interest, additions to the tax, and additional amounts) shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

(b) Individuals in Missing Status.—For purposes of this section, in the case of an individual who was in a missing status within the meaning of section 6013(f)(3)(A), the date of his death shall be treated as being not earlier than the date on which a determination of his death is made under section 556 of title 37 of the United States Code. The preceding sentence shall not cause subsection (a)(1) to apply for any taxable year beginning more than 2 years after—

(1) the date of the enactment of this subsection, in the case of service in the combat zone designated for purposes of the Vietnam conflict, or

(2) the date designated under section 112 as the date of termination of combatant activities in that zone, in the case of any combat zone other than that referred to in paragraph (1).

Section 1.692-1(d) of the Income Tax Regulations provides that for the purpose of determining the tax that is unpaid at the date of death, amounts deducted and withheld under chapter 24, subtitle C of the Code (relating to income tax withheld at source on wages), are payments of tax imposed under subtitle A.

Section 7508(a)(1)(A) of the Code provides for a postponement of time for performing certain acts by reason of war, including postponement of the filing of any return of income, estate or gift tax. However, there is no postponement of the withholding of income tax at source and income tax imposed by subtitle C.

In accordance with section 1.692-1(d) of the regulations the income tax on *A*'s 1970 income was considered paid in 1970 to the extent that amounts were withheld from *A*'s income under chapter 24, subtitle C. Such tax is considered paid even though an income tax return was not filed until after *A*'s death.

Similarly, the income tax on *B*'s 1970 income was considered paid in 1970 when such amounts were withheld.

In both situations, the dates that the taxes were considered to have been paid are not postponed by reason of operation of section 7508 of the Code.

In the instant case, the provisions of section 692(a)(1) of the Code do not apply to the taxable year 1970 for either *A* or *B* since that taxable year ended prior to the first day that *A* or *B* served in a combat zone.

Since *A*'s tax liability for 1970 exceeds the amount withheld on *A*'s 1970 income, the difference is a tax that is unpaid at the date of *A*'s death, in accordance with section 692(a)(2) of the Code. However, the amount withheld on *B*'s 1970 income in 1970 exceeds *B*'s tax liability and there is no unpaid tax at the date of *B*'s death and, therefore, the provisions of section 692(a)(2) do not apply to *B*.

Accordingly, there is no refund due *A*'s estate of the income taxes withheld from *A* in 1970, and *B*'s spouse is entitled to a refund only to the extent of the overpayment of the income taxes withheld on *B*'s income for 1970. Further, the unpaid tax of *A* for 1970 shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

The Secretary of Defense has determined, within authority under section 3122 of the Federal Insurance Contribution Act, that payments to members of the Armed Forces after the tax year in which such members entered a missing status and prior to the presumptive date of death are not "wages" for purposes of the Act.

Accordingly, *A*'s estate and *B*'s spouse may claim a refund of FICA taxes deducted for years 1972 through 1974, but not for 1971, the year in which *A* and *B* entered a missing status.

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26 CFR 1.692-1: Abatement of income taxes of certain members of the Armed Forces of the United States upon death. (Also Sections 2, 112, 6013, 7508.)

Armed Forces; missing in action; date of death. The date of death of a member of the Armed Forces or a civilian employee, reported as missing in action or a prisoner of war and later declared to have been killed in action, is that determined under 37 U.S.C. section 555 or 556 unless a later actual date of death is subsequently established; I.T. 3857 and Rev. Ruls. 55-127 and 72-53 obsoleted.

Rev. Rul. 76-468

The Internal Revenue Service has been asked to clarify Rev. Rul. 72-53, 1972-1 C.B. 198, in light of the subsequent enactment of legislation that modifies the tax treatment of members of the Armed Forces of the United States and civilian employees who are prisoners of war or missing in action.

The question presented in Rev. Rul. 72-53 relates to the date of death to be used for Federal income tax purposes for members of the uniformed services who have been reported missing in action and are later declared to have been killed in action. This determination affects the application of several

sections of the Internal Revenue Code of 1954, among which are sections 2 (a), defining surviving spouse; 112, relating to certain combat pay of members of the armed forces; 692, relating to income taxes of members of armed forces on death; 6013, relating to joint returns of income tax by husband and wife; and 7508, relating to the time for performing acts postponed by reason of war.

Public Law No. 490, 77th Cong., 2d Sess., which was enacted on March 7, 1942, to provide for payment of pay and allowances to missing persons for a limited period not to extend more than 12 months beyond the date on which the person was first reported as missing or missing in action, also authorized a finding of death of such person upon expiration of that period unless affirmative information to the contrary was received. When it became apparent later that year that the enemy countries were not furnishing information regarding prisoners of war as required by the Geneva Convention, this law was amended by Public Law No. 848, 77th Cong., 2d Sess., which permitted the department concerned to direct a continuance of the missing status of such a person and the payment of pay and allowances after the expiration of the 12-month period, if the person could reasonably be presumed to be living. The Federal law relating to payments to missing persons, embodying Public Law No. 490, as amended, is found in 37 U.S.C. sections 551-558 (1970), pertinent parts of which are set out below:

SECTION 551. DEFINITIONS.
In this chapter—

* * * * *

(2) "missing status" means the status of a member of a uniformed service who is officially carried or determined to be absent in a status of—

(A) missing;
(B) missing in action;
(C) interned in a foreign country;
(D) captured, beleaguered, or besieged by a hostile force; or
(E) detained in a foreign country against his will; * * *.

SECTION 552. PAY AND ALLOWANCES: CONTINUANCE WHILE IN A MISSING STATUS; LIMITATIONS.

(a) A member of a uniformed service who is on active duty or performing inactive-duty training, and who is in a missing status, is, for the period he is in that status, entitled to receive or have credited to his account the same pay and allowances, as defined in this chapter, to which he was entitled at the beginning of that period or may thereafter become entitled. * * *

(b) The expiration of a member's term of service while he is in a missing status does not end his entitlement to pay and allowances under subsection (a) of this section. Notwithstanding the death of a member while in a missing status, entitlement to pay and allowances under subsection (a) of this section ends on the date—

(1) the Secretary concerned receives evidence that the member is dead; or
(2) that his death is prescribed or determined under section 555 of this title.

* * * * *

SECTION 553. ALLOTMENTS, CONTINUANCE, SUSPENSION, INITIATION, RESUMPTION, OR INCREASE WHILE IN A MISSING STATUS; LIMITATIONS

(a) Notwithstanding the end of the period for which it was made, an allotment, including one for the purchase of United States savings bonds, made by a member of a uniformed service before he was in a missing status may be continued for the period he is entitled to pay and allowances under section 552 of this title.

* * * * *

SECTION 555. SECRETARIAL REVIEW

(a) When a member of a uniformed service entitled to pay and allowances under section 552 of this title has been in a missing status, and the official report of his death or of the circumstances of his absence has not been received by the Secretary concerned, he shall, before the end of a 12-month period in that status, have the case fully reviewed. After that review and the end of the 12-month period in a missing status, or after a later review which shall be made when warranted by information received or other circumstances, the Secretary concerned, or his designee, may—

(1) if the member can reasonably be presumed to be living, direct a continuance of his missing status; or
(2) make a finding of death.

(b) When a finding of death is made under subsection (a) of this section, it shall include the date death is presumed to have occurred for the purpose of—

(1) ending the crediting of pay and allowances;
(2) settlement of accounts; and
(3) payment of death gratuities.

That date is—

(A) the day after the day on which the 12-month period in a missing status ends; or
(B) if the missing status has been continued under subsection (a) of this section, the day determined by the Secretary concerned, or his designee.

* * * * *

SECTION 556. SECRETARIAL DETERMINATIONS

(a) The Secretary concerned or his designee, may make any determination necessary to administer this chapter and, when so made, it is conclusive as to—

(1) death or finding of death;

* * * * *

(7) whether information concerning a member of a uniformed service is to be construed and acted on as an official report of death.

(b) When the Secretary concerned receives information that he considers establishes conclusively the death of a member of a uniformed service, he shall, notwithstanding any earlier action relating to death or other status of the member, act on it as an official report of death. After the end of the 12-month period in a missing status prescribed by section 555 of this title, the Secretary concerned, or his designee, shall, when he considers that the information received, or a lapse of time without information establishes a reasonable presumption that a member in a missing status is dead, make a finding of death.

* * * * *

The date of death determined under 37 U.S.C. section 555 or under 37 U.S.C. section 556 is referred to hereinafter as the Secretarial determination date of death.

The facts stated in Rev. Rul. 72-53, 1972-1 C.B. 198, are as follows: *A* and *B*, members of the uniformed services of the United States on active duty, were reported in a missing status as of September 29, 1968. In the case of *A*, the Secretary concerned made a finding of *A*'s death on September 30, 1969, pursuant to 37 U.S.C. section 555, and so notified *A*'s surviving spouse. The circumstances of *B*'s case indicated to the military authorities that *B* could reasonably be presumed to be living, and, therefore, *B* was carried as missing on the records of the Department of Defense for several years until evidence of *B*'s death was received. The designee of the Secretary concerned then notified *B*'s surviving spouse that, as of June 15, 1971, a determination had been made that, based on a report of investigation, *B*'s

death had actually occurred on October 15, 1968, but that for the purpose of accounting *B* would be deemed to have died as of June 15, 1971.

Rev. Rul. 72-53 stated that the presumptive date of death when determined under the provisions of 37 U.S.C. section 555 was regarded as conclusive only for the purpose for which Public Law No. 490 was enacted, or where Congress had by collateral legislation made it conclusive for other purposes; and that no such collateral legislation had been adopted by Congress in respect of the Federal income tax laws. Therefore, Rev. Rul. 72-53 concluded that in the administration of the Federal income tax laws, the Service would not recognize the presumptive date of death where an earlier actual date of death of a taxpayer was reliably established. However, where the actual date of death was not reliably established, the presumptive date of death would be adopted by the Service.

Thus, Rev. Rul. 72-53 held that in the case of *A*, where the actual date of death was not reliably established, the presumptive date of death determined pursuant to 37 U.S.C. section 555 and used in the certificate of presumptive death issued in *A*'s case was considered the date of *A*'s death for Federal income tax purposes. However, in the case of *B*, where the actual date of death was known, Rev. Rul. 72-53 held that the actual date was considered the date of *B*'s death for Federal income tax purposes.

Shortly after Rev. Rul. 72-53 was published, Congress enacted Public Law No. 92-279, 1972-1 C.B. 498, one provision of which added new subsection (d) to section 112 of the Code; and on January 2, 1975, Congress enacted Public Law No. 93-597, 1975-1 C.B. 495, which amended various provisions of the Code, including sections 2, 692, 6013, and 7508, in each of which the date of death for taxable years ending on or after February 28, 1961, is involved either directly or collaterally. These provisions of law, with particular reference to the date of death controlling for the purposes of each, are discussed below.

Compensation for active service during missing status (section 112).— The pertinent part of new section 112 (d) of the Code, as enacted by Public Law No. 92-279, is quoted below:

> (d) Prisoners of War, etc.
>
> (1) Members of the armed forces.— Gross income does not include compensation received for active service as a member of the Armed Forces of the United States for any month during any part of which such member is in a missing status (as defined in section 551(2) of title 37, United States Code) during the Vietnam conflict as a result of such conflict, other than a period with respect to which it is officially determined under section 552(c) of such title 37 that he is officially absent from his post of duty without authority.

Since the exclusion from gross income provided by section 112(d) of the Code applies to compensation received for active service of a member of the Armed Forces who, as a result of the Vietnam conflict, is in a missing status as defined in 37 U.S.C. section 551(2), and since 37 U.S.C. section 551(2) defines the term "missing status" as the status of a member of the uniformed services who is "officially" carried or determined to be absent in a status of missing, etc., the exclusion applies to the compensation received for the period the member is "officially" in a missing status even though it later may be determined that the actual date of death preceded that period or occurred during that period. Therefore, this new provision of law is, in effect, collateral legislation making conclusive as the date of death, for purposes of section 112(d), the Secretarial determination date of death, unless a later date of death is subsequently established. It is effective for taxable years ending on or after February 28, 1961.

Accordingly, if *A* and *B* in the illustrative case were members of the Armed Forces to whom section 112(d) of the Code applies, the date of death that is controlling for purposes of that section is the Secretarial determination date of death, that is, September 30, 1969, for *A* and June 15, 1971, for *B*. The resulting income tax effect under section 112(d) is that there is excluded from the gross incomes of *A* and *B* the compensation of each for their active service in the Armed Forces of the United States for the period beginning September 1968 (the month in which both were reported in a missing status) through September 1969 for *A*, and through June 1971 for *B*.

Joint return privileges (section 6013).—With respect to the election to file joint returns of income by husband and wife, Public Law No. 93-597, 1975-1 C.B. 495, added new section 6013(f) to the Code, dealing specifically with joint returns where an individual is in a missing status. Although no specific provision is made in that section regarding the date of death for this purpose, the new section provides that a member of a uniformed service is in a missing status for any period for which the member is entitled to pay and allowances under 37 U.S.C. section 552. Therefore, this new provision of law, in effect, makes the Secretarial determination date of death conclusive as the date of death for purposes of section 6013 unless a later actual date of death is subsequently established. The time within which a joint return may be filed under these circumstances is limited by section 6013(f)(1).

Accordingly, in the illustrative case of *A* and *B*, the date of death that is controlling for purposes of section 6013 of the Code is the Secretarial determination date of death for each of them. The resulting income tax effect under section 6013 is that the spouse of either *A* or *B*, if otherwise entitled to file a joint return for the taxable year, may file joint returns for all taxable years ending on or after February 28, 1961, up to and including the taxable year in which occurred the Secretarial determination date of death for each of them (that is, September 30, 1969, for *A*, and June 15, 1971, for *B*).

Surviving spouse privileges (section

2(a)).—With respect to the definition of a surviving spouse of a member of the uniformed services, Public Law No. 93-597 added new section 2(a)(3) to the Code. That section provides that in the case of an individual in a missing status within the meaning of section 6013(f)(3), if such individual remains in that status until the date referred to in (1) or (2) below, date of death shall be treated as the earlier of (1) the date on which the determination is made under 37 U.S.C. section 556 that such individual died while missing in action, or (2) the applicable date provided in section 2(a)(3).

Although section 2(a)(3) of the Code makes no specific reference to the date of death for one for whom the Secretary concerned or the Secretary's designee made a presumptive finding of death under 37 U.S.C. section 555, its reference to those in a missing status within the meaning of section 6013(f)(3), in effect, makes the Secretarial determination date of death conclusive as the date of death for purposes of section 2(a)(3)(A) of the Code, unless a later actual date of death is subsequently established.

Accordingly, in the illustrative case of *A* and *B*, the date of death that is controlling for purposes of section 2(a) of the Code is the Secretarial determination date of death for each of them. The resulting income tax effect under section 2(a) of the Code is that if the surviving spouse of either *A* or *B* was entitled to file a joint return with the deceased spouse for the taxable year in which occurred the date of death for purposes of section 6013 (that is, September 30, 1969, for *A*, and June 15, 1971, for *B*), regardless of whether the surviving spouse actually did file jointly with the deceased spouse, then the surviving spouse is also entitled to take advantage of the split income rates by claiming "surviving spouse" status for the next two taxable years following the year of death so determined if, during the taxable year, the surviving spouse (1) has not remarried, and (2) has a child or stepchild who qualifies as a dependent within the meaning of section 151(e), and (3) furnishes over half the cost of maintaining a home, which is the principal residence of the dependent child or stepchild for the entire year except for temporary absences.

Forgiveness of income tax for year of death and certain prior years (section 692).—With respect to the forgiveness of income taxes of members of the Armed Forces on death, Public Law No. 93-597 added new section 692(b) of the Code, which provides, in part, that in the case of an individual in a missing status within the meaning of section 6013(f)(3)(A), the date of death shall be treated as not earlier than the date on which a determination of death is made under 37 U.S.C. section 556, but not later than the applicable date provided in section 692(b).

While section 692(b) of the Code makes no specific reference to the date of death of one for whom the Secretary concerned or the Secretary's designee made a presumptive finding of death under 37 U.S.C. section 555, its reference to those in a missing status within the meaning of section 6013(f)(3)(A), in effect, makes the Secretarial determination date of death conclusive as the date of death for purposes of section 692(b), unless a later actual date of death is subsequently established.

Accordingly, if *A* and *B* in the illustrative case were members of the Armed Forces to whom section 692 of the Code applies, the date of death that is controlling for purposes of section 692 is the Secretarial determination date of death for each of them. The resulting income tax effect under section 692 is that if the surviving spouse of either *A* or *B* files joint returns with the member for years up to and including the taxable year in which occurred the date of death for purposes of section 6013 (that is, September 30, 1969, for *A*, and June 15, 1971, for *B*), the amount of tax liability attributable to *A* or *B* under section 1.692-1 of the Income Tax Regulations for the taxable year in which such date of death falls and any prior taxable year ending on or after the first day the member served in a combat zone after June 24, 1950, is, in effect, forgiven by section 692(b).

The time for performing certain acts (section 7508).—With respect to the postponement, by reason of war, of the time for performing certain acts, Public Law No. 93-597 added new subsections (b) and (c) to section 7508 of the Code. Section 7508(b), in making section 7508(a) applicable in the case of the spouse of an individual serving in (or in support of) the Armed Forces of the United States in an area designated by the President of the United States by Executive Order as a "combat zone" for purposes of section 112, postpones the time for the spouse's performing certain acts. However, the provisions of section 7508(a) are limited to the extent that they would not apply to any taxable year of the spouse beginning after the applicable date specified in section 7508(b). Section 7508(c) makes clear that those in a missing status, as defined in section 6013(f)(3), are among those covered by section 7508(a). Therefore, this new provision of law, in effect, makes the Secretarial determination date of death conclusive as the date of death for purposes of section 7508 unless a later actual date of death is subsequently established.

Accordingly, if *A* and *B* in the illustrative case were members of the Armed Forces to whom section 7508 of the Code applies, the date of death that is controlling for purposes of section 7508 is the Secretarial determination date of death for each of them (in the case of *A*, September 30, 1969, and in the case of *B*, June 15, 1971.)

I.T. 3857, 1947-1 C.B. 54, dealt with the tax treatment of pay and allowances of a member of the Armed Forces who was initially reported missing in action in 1943 and was carried in that status until 1945 when it was ascertained that the member was

killed in action in 1943. I.T. 3857 was made obsolete, with respect to taxable years ending on or after February 28, 1961, by the enactment of sections 112(d) and 692(b) of the Code. Rev. Rul. 55-127, 1955-1 C.B. 559, which holds that the period of time to be disregarded under section 3804 of the Internal Revenue Code of 1939 (predecessor to section 7508 of the Internal Revenue Code of 1954) is not applicable to the spouse of a member of the Armed Forces serving in a combat zone if the spouse elects to file a separate return, was made obsolete, with respect to taxable years ending on or after February 28, 1961, by the new provisions of section 7508 (b) of the Code. Rev. Rul. 72-53 was made obsolete, with respect to taxable years ending on or after February 28, 1961, by the provisions of Public Laws No. 92-279 and No. 93-597.

I.T. 3857, Rev. Rul. 55-127, and Rev. Rul. 72-53 are declared obsolete.

Subpart K.—Partners and Partnerships
Part II.—Contributions, Distributions, and Transfers
Subpart D.—Provisions Common to Other Subparts

Section 752.—Treatment of Certain Liabilities

26 CFR 1.752-1: Treatment of certain liabilities.

The extent to which partnership liabilities assumed by the purchaser in a sale of a partnership interest on the installment method will be treated as payments in the year of sale for purposes of the limitations contained in section 453(b) of the Code. See Rev. Rul. 76-483, page 131.

Subchapter I.—Insurance Companies
Part I.—Life Insurance Companies
Subpart A.—Definition; Tax Imposed

Section 801.—Definition of Life Insurance Company

26 CFR 1.801-8: Contracts with reserves based on segregated asset accounts. (Also Section 805; 1.805-8.)

Life insurance company; transfer accounts for funding variable annuity contracts. Interest credited by a life insurance company on accountholders' transfer accounts established as part of a program to provide participants with various means of providing for their financial security, including single payment variable annuity contracts, qualifies as "interest paid" under section 805(e)(1) of the Code. The variable annuity contracts purchased, upon written request of the accountholders, with funds transferred from these accounts qualify as "contracts with reserves based on a segregated asset account" under section 801(g).

Rev. Rul. 76-281

Advice has been requested whether the variable annuity contracts issued by the taxpayer qualify as "contracts with reserves based on a segregated asset account" pursuant to section 801(g) of the Internal Revenue Code of 1954 under the circumstances described below. Advice has also been requested whether, under these circumstances, interest credited to the transfer account of each accountholder is "interest paid" by the taxpayer within the meaning of section 805 (e)(1).

The taxpayer is a life insurance company subject to the tax imposed by section 802 of the Code. It is incorporated under the laws of state *X* and is subject to the state requirements applicable to life insurance companies. The taxpayer established a program that was designed to provide participants and their families with various means of providing for their financial security including, among other contracts, single purchase payment variable annuity contracts. A purchase of any contract issued by the taxpayer that forms part of this financial security program may be made only through the transfer of funds from a transfer account that has been set up under the program. As part of this program, the taxpayer has issued single purchase payment variable annuity contracts that provide for allocation of amounts received to an annuity plan account.

Although the taxpayer markets other insurance contracts through the transfer account, the issue presented here concerns only the Federal income tax treatment by the taxpayer of amounts credited to the transfer account and amounts allocated to the annuity plan account under the variable annuity contracts provided for by the program.

An individual opening a transfer account with the taxpayer is known as an "accountholder" who may at any time, upon written request to the taxpayer, withdraw funds from his or her transfer account, or arrange for payments from the transfer account to purchase a variable annuity contract issued by the taxpayer.

The taxpayer credits interest as of the end of each calendar quarter to the accountholder's transfer account. Deposits in the transfer account earn interest from the date of deposit to the date of transfer or withdrawal. The rate of interest is guaranteed and is established by the taxpayer prior to each calendar year. The taxpayer reserves the right to limit the amount maintained as a balance in the transfer account and the period of time during which it may be maintained, as well as the right to limit the amount of any single deposit.

The variable annuity contract can be in the form of a variable life annuity, a variable life annuity with 120 payments guaranteed, or a variable last survivor life annuity. The variable annuity is computed on the basis of a recognized mortality table, which is a part of the contract, and on the basis of the investment experience of the annuity plan account.

An accountholder may purchase the variable annuity contract provided by the program by making a single payment of the minimum amount required, and directing that such amount, after authorized deductions,

be immediately transferred from the transfer account to the taxpayer's annuity plan account to purchase the variable annuity contract.

Pursuant to the state insurance laws, the assets of the annuity plan account are segregated from the general asset accounts of the taxpayer.

Under state law, the assets held in a segregated account may be invested in shares of any investment company specified in the contract or contracts participating in the segregated asset account and registered under the Investment Company Act of 1940, as amended, 15 U.S.C. sections 80a-1 to 80a-52 (1971) (Act).

The annuity plan account may hold, as assets, only amounts derived from purchase payments made for variable annuities sold by the taxpayer, amounts necessary to comply with the Act, amounts the taxpayer may place in the account for purposes of maintaining a surplus to support the guarantee under the contracts, and amounts derived from the dividends, interest, and gains produced by the investment of the assets in the account. Assets in the annuity plan account, equal in market value to the reserve liability required by law, are held for the sole benefit of all variable annuity contracts that participate in the account.

In the instant case, the assets of the annuity plan account are invested in shares of the taxpayer's own regulated investment company. The annuity plan account is registered under the Act as a unit investment trust and the taxpayer's regulated investment company is registered under the same Act as an open-end diversified management investment company.

The amount paid by the accountholder to purchase the variable annuity contract is converted into units (called "annuity shares"). The value of the units reflect the investment return and market value of the assets in the annuity plan account and, thus, under the variable annuity contract the amount paid as annuities reflects the investment return and market value of the annuity plan account. The variable annuity contract, however, does contain guarantees that neither the number nor the dollar amount of annuity payments will be affected by mortality or sales and administrative expenses. These guarantees are irrevocable with respect to annuities in effect and insurance reserves must be held by the taxpayer to satisfy the mortality guarantees provided by it. In the event that the charges made for expenses and guarantees are inadequate, the general assets of the taxpayer are available to meet and fulfill the obligation for the variable annuities purchased under the program.

Specifically, the questions presented are: (1) whether interest credited to the transfer account by the taxpayer will be deductible when accrued and credited to the transfer account as interest paid under section 805(e)(1) of the Code; and (2) whether the variable annuity contracts issued by the taxpayer qualify as "contracts with reserves based on a segregated asset account" under section 801(g).

Section 805(e)(1) of the Code provides that the interest paid for any taxable year includes all interest for the taxable year on indebtedness, except for indebtedness incurred to purchase obligations the interest on which is wholly tax exempt.

The taxpayer is obligated at all times to pay the amounts in the transfer account to the accountholder or to apply such amounts as the accountholder may direct. The taxpayer's liability with respect to the balance in the transfer account is fixed and unconditional. The interest is credited quarterly by the taxpayer on the balance of the transfer account at a guaranteed rate and, like the principal balance, such interest may also be withdrawn at any time by the accountholder. Accordingly, it is held that such interest is "interest paid" within the meaning of section 805(e)(1) of the Code.

Section 801(g)(1)(B) of the Code defines the term "contract with reserves based on a segregated asset account" as a contract (1) that provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to state law or regulation, is segregated from the general asset accounts of the company; (2) that provides for the payment of annuities; and (3) under which the amounts paid in, or the amount paid as annuities, reflect the investment return and the market value of the segregated asset account.

Section 801(g)(1)(B) of the Code also provides that if a contract ceases to reflect current investment return and current market value, such contract shall not be considered as meeting the requirements of (3) above after such cessation.

The variable annuity contract under the program provides for the allocation of all or a part of the amounts received under the contract to the annuity plan account which, pursuant to state law, is segregated from the general asset accounts of the taxpayer, and provides for the payment of annuities. In addition, it is a contract under which the amounts paid in, or the amounts paid as annuities reflect the investment return and the market value of the segregated asset account. Accordingly, it is further held that the variable annuity contract qualifies as a contract with reserves based on a segregated asset account under section 801(g)(1)(B) of the Code.

Section 802.—Tax Imposed

26 CFR 1.802-3: Tax imposed on life insurance companies.

Whether a mutual savings bank that conducts a life insurance business in a separate department is entitled to compute the alternative tax for such organizations under section 594 of the Code, utilizing the surtax exemptions under section 11(d) in determining both the partial tax on the income of the insurance department and the partial tax on the income of the banking

department, before adding the two partial taxes to determine the overall tax under section 594. See Rev. Rul. 76-476, page 184.

Subpart B.—Investment Income

Section 805.—Policy and Other Contract Liability Requirements

26 CFR 1.805-8: Interest paid.

Whether the interest credited to transfer accounts through which a life insurance company markets variable annuity contracts is "interest paid" as defined in section 805 (e) of the Code. See Rev. Rul. 76-281, page 206.

Subpart D.—Distributions to Shareholders

Section 815.—Distributions to Shareholders

26 CFR 1.815-6: Special rules.

Whether interest can be imposed under section 6601 of the Code on an underpayment of tax that resulted from an adjustment under section 815(d)(2)(A). See Rev. Rul. 76-383, page 429.

Subpart E.—Miscellaneous Provisions

Section 817.—Rules Relating to Certain Gains and Losses

26 CFR 1.817-4: Special rules.

Accident and health insurance policies purchased; amortization. The consideration paid by a life insurance company under an assumption reinsurance agreement in acquiring cancellable accident and health insurance contracts with readily ascertainable useful lives that can be separated from the consideration paid for goodwill may be treated as a deferred expense amortizable over the life of such contracts; Rev. Rul. 69-375 modified.

Rev. Rul. 76-411

Reconsideration has been given to Rev. Rul. 69-375, 1969-2 C.B. 146, in light of the decision of the United States Tax Court in *Union Bankers Insurance Company,* 64 T.C. 807 (1975), acquiescence, page 3, this Bulletin.

In Rev. Rul. 69-375, the Internal Revenue Service took the position that the consideration paid by a life insurance company in acquiring a block of cancellable accident and health policies under an assumption reinsurance agreement (a transaction whereby one insurance company purchases a part or all of the business of another insurance company under which the purchaser or reinsurer becomes solely liable on the contracts transferred) represented the cost of acquiring an intangible asset having an indeterminable useful life. For this reason, it was held that such consideration could not be treated as a deferred expense under section 1.817-4(d) of the Income Tax Regulations and amortized over the reasonably estimated life of the policies acquired.

The court in *Union Bankers Insurance Company* held, in part, that Rev. Rul. 69-375 was in error in its conclusion that cancellable accident and health policies do not have a reasonably estimated life as a matter of law. The court concluded that, if the facts establish that the cost of the blocks of insurance is separate and distinct from goodwill and that the policies within the blocks of insurance acquired have a limited useful life that is readily ascertainable, the amounts paid or cancellable accident and health contracts acquired under an assumption reinsurance agreement could be treated as a deferred expense under section 1.817-4(d) of the regulations that may be amortized over the reasonably estimated life of such contracts. It was found by the court that the burden of proof was met by the reinsurer in establishing that the contracts acquired had an ascertainable cost separate and distinct from goodwill and a limited useful life, the duration of which could be reasonably estimated.

Section 1.817-4(d) of the regulations, as amended by T.D. 7401, 1976-1 C.B. 183, provides, in part, that:

> (1) For any taxable year beginning after December 31, 1958, the reinsurance of all or a part of the insurance contracts of a particular type by life insurance company * * *, whereby the reinsuring company or companies assume all liabilities under such contracts, shall not be treated as the sale or exchange of a capital asset but shall be subject to the provisions of section 806(a) and 809 and the regulations thereunder. * * *
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> (ii) In connection with an assumption reinsurance * * * transaction, a reinsurer shall in any taxable year beginning after December 31, 1957—
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> * * * * *
>
> (b) Treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense that may be amortized over the reasonably estimated life * * * of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.
>
> * * * * *
>
> (iv) For purposes of this subparagraph, the term 'reasonably estimated life' means the period during which the contract remains in force. Such period shall be based on the facts in each case (such as age, health, and sex of the insured, type of contract reinsured, etc.) and the assuming company's experience (such as mortality, lapse rate, etc.) with similar risks.

There is nothing in the above regulations (or the legislative history) to indicate that as a matter of law cancellable accident and health contracts acquired in an assumption reinsurance agreement cannot have a determinable useful life.

Therefore, where it is established that a portion of the consideration paid for cancellable accident and health contracts meets the requirements of section 162 of the Internal Revenue Code of 1954, that portion can be treated as a deferred expense under section 1.817-4(d) of the regulations. As a deferred expense, such consideration may be amortized over the reasonably estimated life of the contracts assumed. *Compare* Rev. Rul. 74-456, 1974-2 C.B. 65, apply-

ing this principle under section 167 in the acquisition of customer and subscription lists, location contracts, and insurance expirations.

Accordingly, in view of the decision in *Union Bankers Insurance Company,* Rev. Rul. 69-375 is modified to the extent that it holds that cancellable health and accident policies do not as a matter of law have a useful life that is reasonably determinable.

Section 819.—Foreign Life Insurance Companies

26 CFR 1.819-2: Foreign life insurance companies.

T.D. 7441

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Percentage to be used by foreign life insurance companies in computing income tax for the taxable year 1975 and estimated tax for the taxable year 1976

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF
INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Treasury Department and Others Concerned:

Preamble

This document contains the proclamation of the Secretary of the Treasury of a revised percentage to be used in determining a "minimum figure" for each foreign corporation carrying on a life insurance business, as provided for under section 819 of the Internal Revenue Code of 1954. It revises the percentage as originally announced on March 15, 1976 (41 F.R. 10910) [T.D. 7412, 1976-1 C.B. 184].

Where this minimum figure exceeds such a corporation's surplus held in the United States, the amount of the "policy and other contract liability requirements" (determined under section 805 without regard to section 819), and the amount of the "required interest" (determined under section 809(a) without regard to section 819), must each be reduced by an amount determined by multiplying such excess by the "current earnings rates" (as defined in section 805(b)(2)).

Proclamation:

It is hereby determined that for purposes of computing the 1975 income tax for foreign corporations carrying on a life insurance business a percentage of 13.2 shall be used in determining the "minimum figure" under section 819 and not 14.8 percent as previously announced on March 15, 1976 (41 F.R. 10910).

Since the data with respect to domestic life insurance companies for 1975 required for the computation of the percentage to be used by foreign corporations carrying on a life insurance business in computing their estimated tax for the taxable year 1976 is not available in time for the filing of the declaration of estimated tax for such taxable year, it is hereby determined that for purposes of computing the estimated tax for the taxable year 1976 and payments of installments thereof by such corporation a percentage of 13.2 (the percentage applicable for 1975) shall be used in determining the minimum figure under section 819. No additions to tax shall be made because of any underpayment of estimated tax for the taxable year 1976 which results solely from the use of this percentage.

Because the percentage announced in this Treasury decision is computed from information contained in the income tax returns of domestic life insurance companies for the year 1974, which are not open to public inspection, the public accordingly cannot effectively participate in the determination of such figure. Therefore, it is found that it is unnecessary to issue this Treasury decision with notice and public procedure thereon under subsection (b) of 5 U.S.C. 553 or subject to the effective date limitation of subsection (d) of that section.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 16, 1976, 8:45 a.m., and published in the issue of the Federal Register for November 17, 1976, 41 F.R. 50649)

Part III.—Other Insurance Companies

Section 832.—Insurance Company Taxable Income

26 CFR 1.832-4: Gross income.
(Also Section 165; 1.165-1, 1.165-8.)

Insurance companies; theft and embezzlement losses; when deductible. A stock casualty insurance company, in computing its losses incurred under section 832(b)(5) of the Code, may treat theft and embezzlement losses as unpaid losses for the taxable year in which the theft or embezzlement occurred, even if such taxable year is not the year the losses are discovered.

Rev. Rul. 76-412

Advice has been requested regarding the proper treatment of theft and embezzlement losses, under the circumstances described below, in computing an insurance company's (other than a life or mutual insurance company) "losses incurred" under section 832(b)(5) of the Internal Revenue Code of 1954.

The taxpayer is a stock casualty insurance company taxable under section 831 of the Code. The taxpayer insures for theft and embezzlement losses. The taxpayer records all theft and embezzlement losses claimed on its books and records as of the date of discovery. However, for purposes of computing its deduction for losses incurred, under section 832(c)(4), the taxpayer makes an estimate based on

its loss experience of the amount it is required to pay as of the end of its taxable year, whether or not specific claims have been made by its policyholders.

Section 832(c)(4) of the Code provides the statutory authority for an insurance company (other than a life or mutual insurance company) to deduct losses incurred.

Section 832(b)(5) of the Code, which defines losses incurred, provides, in part, that in computing losses incurred during the taxable year on insurance contracts, unpaid losses outstanding at the end of the taxable year should be added to, and unpaid losses outstanding at the end of the preceding year should be deducted from, losses paid during the taxable year.

Section 1.832-4(b) of the Income Tax Regulations provides, in part, that insurance companies must be prepared to establish to the satisfaction of the district director that the part of the deduction for losses incurred that represents unpaid losses at the close of the taxable year comprise only actual unpaid losses stated in amounts that, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay.

Section 165(e) of the Code and section 1.165-1(d)(3) of the regulations provide, in part, that any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss. Section 1.165-8 provides, further, that a theft loss is not deductible under section 165(a) for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss.

In the instant case it is the taxpayer's policyholders that sustain the theft and embezzlement losses. The taxpayer reimburses such persons for their losses in satisfaction of its contractual obligation to do so. Such reimbursement of policyholder claims is a portion of losses incurred, as defined by section 832(b)(5) of the Code, and reference must be made to section 832 as to its deductibility rather than to section 165, which has reference to the taxpayer who actually sustains a theft or casualty loss.

Accordingly, in computing its losses incurred on insurance contracts under section 832(b)(5) of the Code, the taxpayer may treat theft and embezzlement losses as "unpaid losses outstanding at the end of the taxable year" in which the theft or embezzlement occurred, even thouguh such taxable year is not the year of discovery of the theft or embezzlement. *See* Rev. Proc. 75-56, 1975-2 C.B. 596, which sets forth the procedures for computing the deduction for losses incurred by a casualty insurance company under section 832(b)(5).

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26 CFR 1.832-4: Gross income.
(Also Section 446; 1.446-1.)

Insurance companies; losses incurred; reduction by estimated salvage. The Service will follow the **Continental Insurance Co.** decision holding that if a state in which a taxpayer transacts insurance business prohibits the recognition of estimates of future salvage recoveries, salvage estimates are not required to be taken into account in computing losses incurred under section 832(b)(5) of the Code and regulations thereunder until reduced to cash or its equivalent. Any taxpayer wishing to change its method of accounting for salvage to a method consistent with that permitted in **Continental** must request the consent of the Commissioner.

Rev. Rul. 76-487

The Internal Revenue Service will follow the decision in *Continental Insurance Co. v. United States*, 474 F.2d 661 (Ct. Cl. 1973), in cases in which the facts are substantially the same as those existing in that case, that is, where a taxpayer does business in at least one state that has an express statute, rule, or regulation that prohibits the recognition of estimates of future salvage recoveries until reduced to cash or its equivalent.

In the *Continental* case, the United States Court of Claims held that if any state in which the taxpayer transacts business prohibits the recognition of estimates of future salvage recoveries, then, for Federal income tax purposes, such estimates are not to be taken into account in computing losses incurred under section 832(b)(5) of the Internal Revenue Code of 1954 and the Income Tax Regulations thereunder until reduced to cash or its equivalent. This case applied equally to all of the taxpayer's business, wherever conducted.

Section 446 of the Code requires the consent of the Commissioner of Internal Revenue before a taxpayer may change its method of accounting for Federal income tax purposes. Section 1.446-1(e)(2)(ii)(a) of the regulations provides:

> A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Accordingly, a consistent method of reducing losses paid by an estimate of future salvage recoveries in computing "losses incurred" is a method of accounting. Any taxpayer transacting insurance business in a state prohibiting the recognition of estimates of future salvage recoveries by reason of express statutory provisions (or rules and regulations of an insurance department) until reduced to cash or its equivalent that wishes to change its method of

accounting for salvage to a method consistent with that permitted in the *Continental* case (that is, taking salvage into account only when reduced to cash or its equivalent) must request the consent of the Commissioner under seciton 1.446-1 of the regulations.

See Rev. Proc. 76-42, page 666, this Bulletin that sets forth certain conditions that must be met by insurance companies wishing to change their method of accounting for salvage under section 832(b)(5) of the Code.

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26 CFR 1.832-4: Gross income.

Conditions that must be met by casualty insurance companies wishing to change their method of accounting for salvage. See Rev. Proc. 76-42, page 666.

Subchapter M.—Regulated Investment Companies and Real Estate Investment Trusts
Part I.—Regulated Investment Companies

Section 851.—Definition of Regulated Investment Company

26 CFR 1.851-2: Limitations.

Tax treatment of certain debentures issued by small business investment companies and guaranteed by the Small Business Administration. See Rev. Rul. 76-426, page 17.

Section 852.—Taxation of Regulated Investment Companies and Their Shareholders

26 CFR 1.852-4: Method of taxation of shareholders of regulated investment companies.
(Also Sections 312, 316, 857; 1.312-6, 1.316-1, 1.852-5, 1.857-4, 1.857-5.)

Earnings and profits; capital loss carryover. A capital loss carryover does not reduce the earnings and profits of a taxable year available for the payment of dividends by a regulated investment company or a real estate investment trust, but it does reduce the amount of a dividend that may be designated as a capital gain dividend.

Rev. Rul. 76-299

Advice has been requested concerning the earnings and profits of the taxable year available for the payment of dividends of a regulated investment company and the taxable status of the company's distribution under the circumstances described below.

In 1970 and prior years *M*, a domestic corporation, qualified as a regulated investment company under subchapter M, chapter 1 of the Internal Revenue Code of 1954.

On January 1, 1969, *M* had zero accumulated earnings and profits available for the payment of dividends. In the taxable year 1969, *M* sustained a net capital loss of 800*x* dollars and had no other income, expenses, or losses. Thus, on January 1, 1970, *M* had a deficit in accumulated earnings and profits of 800*x* dollars and an unused net capital loss of 800*x* dollars from 1969 that was a carryover to 1970. In the taxable year 1970, *M* had 1,000*x* dollars of net long-term capital gain, no short-term capital gains or losses, ordinary income of 10,000*x* dollars, and no other income, expenses, or losses. In 1970, *M* distributed 11,000*x* dollars pro rata to its shareholders, and designated 1,000*x* dollars of this distribution as a capital gain dividend. In determining the amount designated as a capital gain dividend, *M* did not take into account as a short-term capital loss of 1970, the capital loss carryover from 1969.

Section 852(b)(3)(C) of the Code provides that the aggregate amount of dividends that may be capital gain dividends of a regulated investment company with respect to a taxable year is limited to the excess of the net long-term capital gain over the net short-term capital loss of the taxable year.

Section 1212(a) of the Code provides, in part, that if for any taxable year a corporation has a net capital loss, the amount thereof shall be a short-term capital loss in each of the 5 succeeding taxable years to the extent such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year.

Rev. Rul. 60-217, 1960-1 C.B. 301, holds that a regulated investment company, as defined in section 851 of the Code, carries over a net capital loss to succeeding taxable years under the provisions of section 1212 in the same manner as other corporations.

Pursuant to section 1212 of the Code and Rev. Rul. 60-217, a capital loss carryover of a regulated investment company is a short-term capital loss in the succeeding taxable years to which it is carried. Thus, the net short-term capital loss of a taxable year includes a capital loss carryover.

A capital loss carryover does not affect the earnings and profits of the taxable year in which it is used because the loss giving rise to the carryover is reflected in the accumulated earnings and profits at the beginning of the taxable year of the carryover. See section 1.312-6(d) of the Income Tax Regulations.

Section 316 of the Code provides, in part, that the term "dividend" means a distribution to shareholders out of the earnings and profits of the taxable year.

Accordingly, in the instant case, since the capital loss carryover of *M* that was a short-term capital loss of 1969 did not reduce the earnings and profits of 1970 available for the payment of dividends because it was reflected in the deficit in the accumulated earnings and profits of 800*x* dollars on January 1, 1970, *M*'s earnings and profits of the taxable year 1970 available for the payment of dividends were 11,000*x* dollars, attributable to the 1,000*x* dollars of net long-term capital gain and the 10,000*x* dollars of other net income. Thus, the entire distribution of 11,000*x* dollars was paid from the earnings and profits of the taxable year 1970 and was a dividend within the meaning of section 316 of the Code. In addition, the capital loss carryover of 800*x* dollars became a short-term capital loss of the taxable

year 1970 and must be used to reduce the amount of a dividend designated as a capital gain dividend. Thus, for the taxable year 1970 the excess of the net long-term capital gain of 1,000x dollars over the net short-term capital loss of 800x dollars was 200x dollars. The portion of the dividend designated a capital gain dividend by the company that actually was a capital gain dividend was 200x dollars and is treated by the shareholders as the gain from the sale or exchange of a capital asset held for more than 6 months as provided by section 852(b)(3)(B). The balance of the dividend, 10,800x dollars, is includible in the gross income of the shareholders as provided by section 1.852-4(a) of the regulations. Further, M had a deficit in accumulated earnings and profits at January 1, 1971, of 800x dollars. Notwithstanding the designation of 1,000x dollars as capital gain by M, the capital loss carryover of 800x dollars will not be a carryover to a subsequent year.

The conclusions set forth in this Revenue Ruling are also applicable as provided by section 857 of the Code to a similar situation in which the organization is a real estate investment trust that qualifies under subchapter M, chapter 1 of the Code.

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26 CFR 1.852-5: Earnings and profits of a regulated investment company.

Whether a regulated investment company is required to utilize a capital loss carryover to offset the amount of a distribution which it may designate as a capital gain dividend pursuant to section 852(b)(3) of the Code. See Rev. Rul. 76-299, page 211.

Part II.—Real Estate Investment Trusts

Section 856.—Definition of Real Estate Investment Trust

26 CFR 1.856-1: Definition of real estate investment trust.

Real estate investment trust; sales of mortgages. A real estate investment trust that, to protect its investment in a construction loan to a builder of town houses, made mortgage loans to purchasers for whom the builder could not arrange financing and immediately sold them to investors at no profit or premium was not holding the mortgages primarily for sale in the ordinary course of its business under section 856(a)(4) of the Code.

Rev. Rul. 76-327

Advice has been requested whether, under the circumstances described below, a real estate investment trust is holding property primarily for sale to customers in the ordinary course of its trade or business within the meaning of section 856(a)(4) of the Internal Revenue Code of 1954.

An unincorporated trust, otherwise qualifying as a real estate investment trust under section 856 of the Code, made a loan to finance the construction of 50 townhouse units to be sold individually upon completion to individual purchasers. The duration of the loan was 30 months, and the principal amount of the loan was to be repaid from the proceeds of the sales of the units to the ultimate purchasers. When the loan was due, 20 of the townhouses had been completed and sold, and less than one half of the principal amount had been repaid. The borrower was unable to pay any of its debts, and it estimated that it would incur additional construction costs to complete and sell the remaining units and that the sales of those units would not be completed for approximately two years.

In order to avoid the bankruptcy of the borrower and to permit an orderly liquidation of the borrower's properties, the borrower and all of its secured creditors, including the trust, entered into an agreement under which the creditors agreed not to demand payment of the borrower's indebtedness and not to foreclose the borrower's secured loans. In addition, the trust agreed to extend the maturity date of its loan to the borrower for two years and to advance the amount required to complete the construction of the townhouses. Because the borrower was unable to obtain long-term mortgage financing for the purchasers, the trust further agreed to make mortgage loans to the purchasers of the remaining 30 units. Since the trust had not intended to make these loans and because of the administrative duties and expense involved in servicing the 30 individual loans, the trust immediately sold the mortgages, singly and in groups, to other investors.

The trust had not previously sold any mortgages or other property, and it does not expect to engage in any other selling activities. The trust did not, nor did it attempt to, receive any profit from or premium on the sales of the mortgages.

Section 856(a) of the Code provides, in part, that the term real estate investment trust means an unincorporated trust or an unincorporated association that does not hold any property primarily for sale to customers in the ordinary course of its trade or business.

Section 1.856-1(d)(4) of the Income Tax Regulations provides that a real estate investment trust may not hold any property primarily for sale to customers in the ordinary course of its trade or business. Whether property is held for sale to customers in the ordinary course of the trade or business of a real estate investment trust depends upon the fact and circumstances in each case.

In the instant case, when the trust made the construction loan, it had no intention of making any mortgage loans to the purchasers of the townhouses. The trust made the mortgage loans to protect its investment in the construction loan by enabling the original borrower to pay the outstanding principal and interest on the construction loan as the townhouses were sold. The trust sold the mortgages because it was not equipped to service many long-term loans for small

amounts. It received no profit or premium as a result of the sales of the mortgages.

Accordingly, in the instant case, the trust was not holding the mortgages primarily for sale to customers in the ordinary course of its trade or business within the meaning of section 856 (a) (4) of the Code.

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26 CFR 1.856-1: Definition of real estate investment trust.

Real estate investment trust; assignment of construction note and mortgage. A real estate investment trust that makes a construction loan and, at the completion of construction and pursuant to an agreement with the borrower and the permanent mortgagee, assigns the borrower's note and mortgage to the permanent mortgagee upon its payment of the outstanding principal and interest is not holding property primarily for sale to customers in the ordinary course of its trade or business within the meaning of section 856(a)(4) of the Code.

Rev. Rul. 76-356

Advice has been requested whether, under the circumstances described below, a real estate investment trust that makes an assignment of a note and mortgage is holding property primarily for sale to customers in the ordinary course of its trade or business within the meaning of section 856 (a) (4) of the Internal Revenue Code of 1954.

An unincorporated trust, otherwise qualifying as a real estate investment trust under section 856 of the Code, invests in construction loans that are secured by first mortgages on the land and the buildings constructed thereon. The construction loans finance the cost of construction and mature on the date construction is completed. The loan proceeds used to finance the construction are advanced as the construction progresses. The principal amount of the loan, and the interest accrued thereon, is payable in full upon maturity of the loan at the time the construction is completed. During the existence of the loan, the trust is subject to all risks relating to the possible default of the borrower. The trust has the right upon default to enter into possession and cause the performance of all work necessary to complete construction.

In connection with making the loan the trust requires the borrower to obtain a commitment from a permanent mortgagee to lend money to the borrower upon the maturity of the construction loan. To assure the trust that the funds will be available to discharge the construction loan upon its maturity, the borrower assigns the commitment to the trust. The trust, the borrower, and the permanent mortgagee then enter into an agreement providing for the closing of the long-term loan. The agreement refers to the commitment made by the permanent mortgagee and provides for the trust to receive the principal amount outstanding on the construction note at the completion of the construction, plus accrued interest thereon. As a matter of mechanics, rather than making the payment to the borrower, who would pay off the construction loan to the trust upon cancellation of the construction note and mortgage, the permanent mortgagee makes the payment directly to the trust. The trust then assigns the construction note and the mortgage to the permanent mortgagee (without recourse to the trust). Upon assignment, the construction note is modified by an agreement between the permanent mortgagee and the borrower to provide that the note will bear the terms and conditions of the permanent loan. The construction loan obligation of the borrower is satisfied and a debtor-creditor relationship is established between the permanent mortgagee and the borrower that did not previously exist.

Section 856(a) of the Code provides, in part, that the term "real estate investment trust" means an unincorporated trust or association that, among other things, does not hold any property primarily for sale to customers in the ordinary course of its trade or business.

Section 1.856-1(d)(4) of the Income Tax Regulations provides that whether property is held for sale to customers in the ordinary course of the trade or business of a real estate investment trust depends upon the facts and circumstances in each case.

In the instant case, there exists a debtor-creditor relationship between the trust and the borrower. The borrower remains primarily obligated to satisfy the construction loan until the trust is paid the outstanding principal and interest accrued thereon by the permanent mortgagee at the time of the maturity of the construction loan. This payment and the corresponding assignment of the note and mortgage by the trust to the permanent mortgagee extinguishes the prior indebtedness of the borrower to the trust and creates a new debtor-creditor relationship between the borrower and the permanent mortgagee. Thus, the assignment of the note is not a sale.

Accordingly, in the instant case, the trust is not holding property primarily for sale to customers in the ordinary course of its trade or business within the meaning of section 856(a)(4) of the Code merely by reason of the assignment.

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26 CFR 1.856-2: Limitations.

Real estate investment trust; contingent interest. Contingent interest received by an otherwise qualifying real estate investment trust from a corporation, under a land development loan agreement and note that provide for a fixed rate of interest plus additional contingent interest of the greater of 1.75 percent of the gross receipts

or $300 per acre from the sale of portions of the property, qualifies as "interest" and as "interest on obligations secured by mortgages on real property" within the meaning of section 856(c) of the Code.

Rev. Rul. 76-413

Advice has been requested whether, under the circumstances described below, "contingent interest" qualifies as "interest" and "interest on obligations secured by mortgages on real property" within the meaning of section 856(c) of the Internal Revenue Code of 1954.

An unincorporated trust, otherwise qualifying as a real estate investment trust, entered into a loan agreement with corporation *X*. Under the agreement *X* borrowed $4,500,000 from the trust for a term of five years to be used solely to acquire 200 acres of land and to develop the land to make it suitable for use as an industrial park. At the same time *X* executed and delivered to the trust a promissory note and a mortgage on the land securing the note. As additional security, *X* assigned all rental and other income from the acreage to the trust. It is estimated that the land as developed will have a fair market value of $5,000,000. *X* plans to sell the land once it is developed.

The loan agreement and the note provided for a fixed annual rate of 11 percent interest on the amount of the loan plus additional contingent interest equal to the greater of (1) 1.75 percent of the gross receipts from the sale of portions of the acreage, or (2) $300 per acre upon its sale. The amount of interest payable on the loan is not to exceed the maximum amount of interest permitted by law.

The fixed rate of interest is payable on the first day of each month on the disbursed loan funds. The entire principal amount is due and payable no later than at the end of five years and the trust will not be entitled to any contingent interest payments after the payment of the entire principal amount by *X*.

The payment of contingent interest is due and payable as portions of the acreage are sold and released from the lien of the mortgage. *X* is entitled to a release upon the sale of portions of the acreage to unrelated third parties by paying the trust a pro-rata portion of the principal amount of the loan as required under the loan agreement. Amounts received as release payments other than contingent interest will be applied against the principal of the note.

For the first four years of the term of the loan, no prepayments may be made aside from the payments of principal required to obtain the release of portions of the acreage. There is no restriction on prepayment by *X* in the fifth year of the term of the loan. *X* is not obligated to make any sales of the acreage at any time during the term of the loan. The trust has not performed and is not obligated to perform any services on behalf of *X* in return for the payment of contingent interest.

Section 856(c) of the Code provides that a trust shall not be considered a real estate investment trust for any taxable year unless, among other things, certain gross income requirements are satisfied. Section 856(c)(2) provides that at least 90 percent of the trust's gross income must be derived from specified sources, including, under section 856(c)(2)(B), interest. Section 856(c)(3) provides that at least 75 percent of the trust's gross income must be derived from specified sources, including, under section 856(c)(3)(B), "interest on obligations secured by mortgages on real property or on interests in real property."

Section 1.856-2(c)(2)(ii) of the Income Tax Regulations provides that in computing the percentage requirements for section 856(c)(2)(B) and (3)(B) of the Code there shall be included as interest only that amount which constitutes lawful interest for the loan or forebearance of money.

The legislative history of the real estate investment trust provisions indicates that the conduit tax treatment accorded such trusts is intended to be limited to income from passive investments. *H.R. Rep. No. 2020*, 86th Cong., 2d Sess. 3 (1960), 1960-2 C.B. 819. In this connection, section 856(d)(1) of the Code, which permits rental income to be based upon gross receipts but not upon net profits, was designed to assure that no profit-sharing arrangement will in effect make the trust an active participant in the operation of property. In the instant case, consistent with section 856(d)(1), the fact that amounts paid to the trust by *X* may be based upon the gross receipts or sales of *X* does not by itself render the trust in effect an active participant in *X*'s business.

Interest has been defined as the compensation allowed by law or fixed by the parties for the use, forbearance, or detention of money. *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552 (1932), XI-1 C.B. 274 (1932); *Deputy v. DuPont*, 308 U.S. 488 (1940), 1940-1 C.B. 118.

The method of computation does not control a payment's characterization as interest, so long as the amount in question is an ascertainable sum contracted for the use of borrowed money. See Rev. Rul. 69-188, 1969-1 C.B. 54; *Kena, Inc.*, 44 B.T.A. 217 (1941). Therefore, the fact that the contingent interest in the instant transaction is computed as the greater of a percentage of the mortgagor's gross receipts or a fixed dollar amount per acre sold does not alter the characterization of that amount as interest under section 856(c) of the Code.

Accordingly, the income received by the trust from *X* in the form of contingent interest qualifies as interest and as "interest on obligations secured by mortgages on real property" under section 856(c) of the Code.

26 CFR 1.856-2: Limitations.

Tax treatment of certain debentures issued by small business investment companies and guaranteed by the Small Business Administration. See Rev. Rul. 76-426, page 17.

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26 CFR 1.856-4: Rents from real property.

Real estate investment trust; management company; qualification as independent contractor. A management company, a wholly owned subsidiary of a real estate investment trust's adviser, that operates as a separate entity from the adviser with separate officers, employees, and books and records but has a non-employee director who is a director-employee of the adviser is not precluded from qualifying as an independent contractor for the management of the trust's properties.

Rev. Rul. 76-534

Advice has been requested whether, under the circumstances described below, a management company of a real estate investment trust qualifies as an independent contractor for purposes of section 856(d) of the Internal Revenue Code of 1954.

The investment adviser of a real estate investment trust owns all the stock of a management company that manages the trust's properties. The management company is paid reasonable fees for its management services and maintains its own separate books and records which clearly reflect its activities in the management of the properties. Neither the management company nor the adviser owns any shares of beneficial interest in the trust.

A is an employee of the adviser and a director of both the adviser and the management company. No employee or officer of either the trust, the adviser, or the management company is an employee) or officer of either of the other two entities.

Section 856(c)(3) of the Code provides, in part, that for a trust to qualify as a real estate investment trust for Federal income tax purposes, a certain percentage of its gross income must be derived from specified sources, including "rents from real property."

Section 856(d) of the Code, in effect, excludes from the definition of "rents from real property" amounts received with respect to real property, if the trust furnished or rendered services to the tenants of the property or managed or operated the property other than through an independent contractor from whom the trust itself did not derive or receive any income.

Section 1.856-4(b)(3)(i)(*b*) of the Income Tax Regulations provides, in part, that, under section 856(d) of the Code, the trust, through its trustees or its own employees, may not directly furnish or render any services to the tenants of its property and may not directly manage or operate the property.

Rev. Rul. 75-136, 1975-1 C.B. 195, holds that a wholly owned subsidiary of an investment adviser to a real estate investment trust is not precluded from qualifying as an independent contractor if it operates as a separate entity with its own separate officers and employees and keeps its own separate books and records that clearly reflect its activities in the management of the property. The Revenue Ruling states that it is the relationship of the entity or individual such as an employee or trustee) to the trust itself that precludes the entity from qualifying as an independent contractor for the management of the property: A relationship between the entity or individual and the trustee, employee, or investment adviser of the trust would not in itself disqualify the entity, assuming the other requirements for qualification as an independent contractor are met.

In the instant case, the management company is not directly related to the trust, but it is a wholly owned subsidiary of the adviser. The management company operates as a separate entity from the adviser with its own separate officers and employees and keeps its own books and records that clearly reflect its activities in the management of the properties. Although *A* is a director of both the adviser and the management company, *A* is an employee of only the adviser, so that the relationship of *A* to the adviser and the management company does not preclude the latter from qualifying as an independent contractor for the management of the trust's properties.

Accordingly, in the instant case, the management company qualifies as an independent contractor for purposes of section 856(d) of the Code.

Section 857.—Taxation of Real Estate Investment Trusts and Their Beneficiaries

26 CFR 1.857-4: Method of taxation of shareholders of real estate investment trusts.

Whether a regulated investment company is required to utilize a capital loss carryover to offset the amount of a distribution which it may designate as a capital gain dividend pursuant to section 852(b)(3) of the Code. See Rev. Rul. 76-299, page 211.

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26 CFR 1.857-5: Earnings and profits of a real estate investment trust.

Whether a regulated investment company is required to utilize a capital loss carryover to offset the amount of a distribution which it may designate as a capital gain dividend pursuant to section 852(b)(3) of the Code. See Rev. Rul. 76-299, page 211.

Section 858.—Dividends Paid by Real Estate Investment Trust After Close of Taxable Year

26 CFR 1.858-1: Dividends paid by real estate investment trust after close of taxable year.

Real estate investment trust; dividends paid after close of taxable year. A real estate investment trust that timely filed its return may elect, under section 858 of the Code, to treat a dividend declared and paid during the taxable

year, that was more than sufficient in amount to reduce the trust's taxable income for the prior year to zero, as having been paid during the prior year to the extent of undistributed earnings and profits for that year. If an audit adjustment subsequently increases the trust's earnings and profits for the prior year and if the amount of the dividend exceeds the earnings and profits before the adjustment, an additional amount of the dividend will be treated as having been paid during the prior year up to the amount of adjustment.

Rev. Rul. 76-271

Advice has been requested regarding the amount of a dividend that a real estate investment trust may elect to treat as having been paid during the trust's prior taxable year under section 858 of the Internal Revenue Code of 1954.

An unincorporated trust, qualifying as a real estate investment trust under section 856 of the Code, files its Federal income tax returns on a calendar year basis. In its timely filed return for 1974, the trust elected to treat a dividend of x dollars declared on January 15, 1975, and distributed to shareholders during 1975, as having been paid during 1974, to the extent described below. The trust did not make such an election for 1973, and it did not declare another dividend in 1975. The dividend was more than sufficient in amount to reduce the trust's taxable income on its return for 1974 to zero, on the basis of the earnings and profits as computed by trust. The trust in addition elected to treat as having been paid during 1974 an additional amount of the 1975 dividend of x dollars to equal any increase in taxable income that may be determined by the Internal Revenue Service upon examination of the trust's 1974 return, to the extent of the trust's earnings and profits as thus increased for 1974.

Section 857(a)(1) of the Code requires that a real estate investment trust distribute at least 90 percent of its taxable income (plus at least 90 percent of its after tax income from foreclosure property) for each taxable year.

Section 858(a) of the Code provides, in part, that if a real estate investment trust declares a dividend before the time prescribed by law for the filing of its return for a taxable year (including the period of any extension of time granted for filing such return), and distributes the amount of such dividend to shareholders or holders of beneficial interests in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration, the amount so declared and distributed shall, to the extent the trust elects in such return, be considered as having been paid during such taxable year.

Section 1.858-1(b) of the Income Tax Regulations provides, in part, that the election provided in section 858 (a) of the Code may be made only to the extent that the earnings and profits of the taxable year exceed the total amount of distributions out of such earnings and profits actually made during the taxable year. *See* example (2) of section 1.858-1(d) and Rev. Rul. 69-191, 1969-1 C.B. 190.

The treatment of corporate distributions as dividends depends on whether the distributions are made out of earnings and profits. Sections 301(c)(1) and 316(a) of the Code. In determining the amount of dividend distributions, the Service is not bound by the earnings and profits shown on a corporation's income tax return. If, upon examination by the Service, a corporation's earnings and profits are found to be incorrect on its return, distributions made by the corporation are treated as dividends to the extent of the correct earnings and profits. *See, Robert Deutsch,* 38 T.C. 118 (1962); *Estate of Esther M. Stein,* 25 T.C. 940, 966 (1956), *aff'd per curiam,* 250 F. 2d 798 (2d Cir. 1958).

Accordingly, in the instant case, the trust may elect under section 858 of the Code to treat the amount of the dividend of x dollars declared and paid during 1975 as having been paid during 1974 to the extent of undistributed earnings and profits for 1974. If an audit adjustment subsequently increases the trust's earnings and profits for 1974 and if the amount of the dividend paid during 1975 exceeds the amount of the trust's earnings and profits before the adjustment, an additional amount of the dividend declared and paid during 1975 will be treated as having been paid during 1974 up to the amount of the adjustment.

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26 CFR 1.858-1: Dividends paid by real estate investment trust after close of taxable year.

Real estate investment trust; deemed distribution. The deemed distribution resulting from an increase in the conversion ratio of convertible debentures on January 31, 1976, reflecting dividends paid by a calendar-year real estate investment trust in 1975 to its shareholders, the sum of the cash and deemed distributions being less than the trust's earnings and profits for 1975, is not the "first regular dividend payment" described in section 858(a) of the Code and may be treated as having been paid in 1975.

Rev. Rul. 76-328

Advice has been requested whether, under the circumstances described below, a deemed distribution by a real estate investment trust to its debenture holders is the "first regular dividend payment" described in section 858(a) of the Internal Revenue Code of 1954 for purposes of the election under section 858(a).

An unincorporated trust, qualifying as a real estate investment trust under section 856 of the Code, files its Federal income tax returns on a calendar year basis. The trust has outstanding debentures that are convertible into shares of beneficial interest of the trust in accordance with a specific formula. The debentures were issued to the trust's shareholders. The conversion ratio of the debentures is subject to an annual adjustment on January 31 to reflect the differential between the interest rate paid on the debentures and the yield that could have been obtained by investing in the shares of the trust on the date the debentures were issued. The trust paid a cash dividend to its shareholders in 1975. As a result of such payment, the conversion ratio of the debentures was increased on January 31, 1976, thereby entitling the debenture holders to acquire additional shares of the trust upon the conversion of the debentures.

Under Rev. Rul. 75-513, 1975-2 C.B. 114, the adjustment in the conversion ratio is a deemed distribution to the debenture holders of property to which section 301 of the Code applies by reason of section 305(b)(2) and (c). The trust's earnings and profits for 1975 exceeded the amount of the distribution deemed to have been made on January 31, 1976, and the total amount of cash distributions actually paid during 1975. No other dividend was declared and distributed during January 1976. Thus, the deemed distribution qualifies as a dividend defined in section 316. See Rev. Rul. 76-186, 1976-1 C.B. 86. It also qualifies as a dividend defined in section 561.

The trust made an election under section 858(a) of the Code to treat the deemed dividend distribution made on Januarly 31, 1976, as having been paid during 1975. The trust did not make such an election for 1974.

Section 858(a) of the Code provides, in part, that if a real estate investment trust declares a dividend before the time prescribed by law for the filing of its return for a taxable year (including the period of any extension of time granted for filing such return), and distributes the amount of such dividend to shareholders or holders of beneficial interests in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration, the amount so declared and distributed shall, to the extent the trust elects in such return, be considered as having been paid during such taxable year.

Rev. Rul. 69-445, 1969-2 C.B. 148, concerns a regulated investment company that made distributions in the current year of income received in the previous year. The dividends were declared after the close of the taxpayer's prior taxable year but before the time prescribed by law for filing its return for the prior year and were distributed during the current year before the taxpayer's distribution of its current year's earnings. That Revenue Ruling holds that, since the distributions were made from income received in the previous year and were made no later than the first distribution from the income of the current year, for purposes of section 855(a) of the Code, none of the distributions was the "first regular dividend payment" made after the declaration. See also Rev. Rul. 64-30, 1964-1 (Part 1) C.B. 232, which holds similarly with respect to distributions made by a real estate investment trust for purposes of section 858(a).

Example (2) of section 1.858-1(d) of the Income Tax Regulations and Rev. Rul. 69-191, 1969-1 C.B. 190, describe the application of section 858(a) of the Code where dividends declared by a real estate investment trust after the close of its taxable year but before the date on which it is required to file its return exceed the amount of the trust's undistributed earnings and profits of the previous year. In both Example (2) and Rev. Rul. 69-191, the application of section 858(a) of the Code to qualifying dividend payments is restricted to the remaining earnings and profits of the previous year.

Thus, the "first regular dividend payment" is the first dividend payment or portion thereof to which the trust does not elect to apply section 858(a) of the Code or which exceeds the trust's remaining undistributed earnings and profits of the previous year.

In the instant case, the deemed distribution on January 31, 1976, when added to the total amount of cash distributions actually paid during 1975 did not exceed the amount of the trust's earnings and profits for 1975.

Accordingly, for purposes of the election under section 858(a) of the Code, the deemed dividend distribution on January 31, 1976, to the debenture holders was not the "first regular dividend payment" described in section 858(a) and may be treated as having been paid in 1975.

Subchapter N.—Tax Based on Income From Sources Within or Without the United States
Part I.—Determination of Sources of Income

Section 861.—Income From Sources Within the United States

26 CFR 1.861-1: Income from sources within the United States.
(Also Sections 381, 881, 1441, 1442; 1.381(a)-1, 1.881-1, 1.1441-1, 1.1442-1.)

Income source; interest and dividends paid foreign corporation; withholding. The surviving domestic corporation in a statutory merger must take into account the total gross income of the merged domestic corporation for the merged corporation's pre-merger years in applying the computational tests of sections 861(a)(1)(B) and 861(a)(2)(A) of the Code to determine the source of interest and dividends received from the surviving corporation and the obligation to with-

hold tax on such dividends and interest paid to a foreign corporation.

Rev. Rul. 76-300

Advice has been requested whether, under the circumstances described below, the gross income of a domestic corporation, the assets of which were acquired by the taxpayer corporation in a statutory merger, should be taken into account with respect to pre-merger years, in applying the source of income tests of sections 861(a)(1)(B) and 861(a)(2)(A) of the Internal Revenue Code of 1954.

On January 1, 1974, *X*, a domestic corporation, in exchange for its stock, acquired all the assets of *Y*, another domestic corporation, in a merger of the two corporations, pursuant to the laws of the state where *X* was incorporated. The transaction was a reorganization as defined in section 368(a)(1)(A) of the Code to which section 361 applied and by reason thereof the provisions of section 381 were applicable. For its taxable years 1973 and 1972, all of *X*'s gross income in the amounts of $4x$ dollars and $3x$ dollars, respectively, was derived from sources without the United States. *Y* had gross income of $2.5x$ dollars for each of its taxable years 1973 and 1972, all of which was derived from sources within the United States. For its first post-merger year, 1974, *X* had gross income of $8x$ dollars, all of which was sourced without the United States. All of the gross income of *X* and *Y* for such periods was derived from the active conduct of a trade or business.

During 1975, *X* was obligated to pay *Z*, a foreign corporation resident in country *M* and not engaged in trade or business within the United States, $2x$ dollars in interest and $1x$ dollars in dividends. The United States has no treaty with *M* exempting such payments from withholding tax or reducing the amount of such withholding.

Section 881(a)(1) of the Code imposes for each taxable year a tax of 30 percent on the amount received from sources within the United States by foreign corporations as interest (other than original issue discount) and dividends, but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

Section 1441(a) of the Code provides for the withholding of tax at a 30 percent rate on certain items of income of nonresident alien individuals specified in section 1441(b) that are from sources within the United States and that are not effectively connected with the conduct of a trade or business within the United States. The items of income specified in section 1441(b) include interest (other than original issue discount) and dividends.

Section 1442(a) of the Code provides, in part, that in the case of a foreign corporation subject to taxation under subtitle A, chapter 1, of the Code, there shall be deducted and withheld at the source in the same manner, and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof.

Section 861(a)(1)(B) of the Code provides, in part, that interest received from a domestic corporation shall not be treated as income from sources within the United States when it is shown to the satisfaction of the Secretary of the Treasury or the Secretary's delegate that less than 20 percent of the gross income from all sources of such corporation has been derived from sources within the United States for the 3-year period ending with the close of the taxable year of such corporation preceding the payment of such interest.

Section 861(a)(2)(A) of the Code provides, in part, that dividends received from a domestic corporation shall not be treated as income from sources within the United States, when it is shown to the satisfaction of the Secretary or the Secretary's delegate that less than 20 percent of the gross income of such corporation has been derived from sources within the United States for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends.

The specific issue in the instant case is whether, as a result of the statutory merger between *X* and *Y*, the gross income of *Y* for its taxable years 1972 and 1973 must be included with *X*'s gross income in applying the tests of section 861(a)(1)(B) and 861(a)(2)(A) of the Code with respect to whether *X* meets the requirement that less than 20 percent of its income be derived from sources within the United States for the 3-year period ending with 1974.

Section 381 of the Code provides, in part, that, in certain corporate acquisitions, the acquiring corporation shall succeed to and take into account certain items described in section 381(c). Gross income used for purposes of applying the computational tests of section 861 is not an item so described. However, section 1.381(a)-1(b)(3) of the Income Tax Regulations provides, in part, that where section 381 of the Code does not apply to a transaction, item, or tax attribute as specified in section 381(c), no inference is to be drawn from the provisions of section 381 as to whether any item or tax attribute shall be taken into account by the successor corporation.

Rev. Rul. 72-356, 1972-2 C.B. 452, holds that the surviving corporation in a statutory merger must take into account its total gross income and that of the merged corporation for the pre-merger years in complying with the computational tests of section 921 of the Code, which is similar to the computational tests of sections 861(a)(1)(B) and 861(a)(2)(A). As in the instant case, gross income used for purposes of applying the section 921 test is not an item described in section 381(c) that must be taken into account by a successor corporation.

Accordingly, in the instant case, in determining whether X, the surviving corporation, has derived less than 20 percent of its gross income from sources within the United States under section 861 of the Code for the 3-year period ending with 1974, X must take into account the total gross income of X and Y for their pre-merger taxable years 1973 and 1972 as well as its own gross income for the post-merger taxable year 1974 in applying the computational tests of sections 861(a)(1)(B) and 861(a)(2)(A). Thus, although all of X's income for the taxable years 1974, 1973, and 1972 was derived from sources without the United States, the inclusion of Y's gross income for the taxable years 1973 and 1972, all of which was derived from sources within the United States, in the computational tests of sections 861(a)(1)(B) and 861(a)(2)(A) results in X's deriving 20 percent or more of its gross income from sources within the United States for the 3-year period ending with 1974, as illustrated below.

Taxable Year	X's income (all sourced without the United States	Y's income (all sourced within the United States
1974	$8x$	—
1973	$4x$	$2.5x$
1972	$3x$	$2.5x$
Total for 3-year period	$15x$	$5x$

$\frac{15x}{20x} = 75$ percent sourced without the United States

$\frac{5x}{20x} = 25$ percent sourced within the United States

Consequently, because 20 percent or more of X's gross income for the 3-year period ending with 1974 is derived from sources within the United States, dividends and interest paid by X to Z are deemed to be from sources within the United States and therefore, X must withhold, under section 1442(a) of the Code, a tax of 30 percent on the $2x$ dollars of interest and the $1x$ dollars of dividends paid to Z.

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26 CFR 1.861-2: Interest.
(Also Sections 863, 931; 1.863-6, 1.931-1.)

Income source; interest from corporation doing business in Puerto Rico. For purposes of section 931 of the Code, 85 percent of the interest received by a domestic corporation from another unrelated domestic corporation that earned 85 percent of its gross income from manufacturing operations in Puerto Rico and 15 percent from sources within the U.S. is income from sources within Puerto Rico. All the interest is income from sources without the U.S. for purposes of section 861(a)(1)(B).

Rev. Rul. 76-535

Advice has been requested as to the proper application of the interest income source rules provided in section 861 of the Internal Revenue Code of 1954 under the circumstances described below in determining the application of section 931, as in effect prior to the enactment of section 1051 of the Tax Reform Act of 1976, Pub. L. 94-455, 94th Cong., 2d Sess. (October 4, 1976.)

M, a domestic corporation, was organized to do business in Puerto Rico. M constructed a manufacturing plant in Puerto Rico in 1974. For its first fiscal year of doing business in Puerto Rico, ending July 31, 1975, M earned 85 percent of its gross income from its manufacturing operations in Puerto Rico. The remaining 15 percent of its gross income was derived from sources within the United States. M qualified as a "possessions corporation" within the meaning of section 931 of the Code for the fiscal year ending July 31, 1975.

In 1974 M borrowed $2{,}500x$ dollars from T, an unrelated domestic corporation that has qualified since its inception as a possessions corporation under section 931 of the Code. The funds borrowed by M were used to refinance certain of its existing debts with respect to the construction of its manufacturing plant and to provide working capital. M is required to repay the loan principal and interest in quarterly installments that began on October 1, 1974. M made the required payments out of the funds derived from its business operations in Puerto Rico for its fiscal year ended July 31, 1975.

Section 931(a) of the Code provides, in part, that in the case of a domestic corporation, gross income means only gross income from sources within the United States if the conditions set forth in section 931(a)(1) and (2) are met.

Section 931(a)(1) and (2) of the Code provides, in part, that a domestic corporation qualifies for the benefits of that section of 80 percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such period immediately preceding the close of the taxable year as may be applicable) was derived from sources within a possession of the United States; and if 50 percent or more of its gross income for such period was derived from the active conduct of a trade or business within a possession of the United States.

The specific question is whether the interest payments made by M to T will be treated as income from sources within the United States or income from sources within Puerto Rico for purposes of qualifying T as a possessions corporation under section 931 of the Code.

In order to determine the source of the interest paid by M to T, it is necessary to apply the source rules set forth in section 861(a)(1)(B), (C), and (D) of the Code. The source rule set forth in section 861(a)(1)(B) is used to determine whether the interest paid by M is from sources within or

without the United States. If it is determined that the interest is from sources without the United States, it is also necessary to determine its geographic source in order to ascertain *T*'s qualification under section 931. The source rules of section 861(a)(1)(C) and (D) are used to determine the geographic source of the interest paid by reason of the application of section 1.863-6 of the Income Tax Regulations.

Section 861(a)(1)(B) of the Code provides that interest received from a resident alien individual or a domestic corporation shall not be treated as income from sources within the United States when it is shown to the satisfaction of the Secretary of the Treasury or the Secretary's delegate that less than 20 percent of the gross income from all sources of such individual or such corporation has been derived from sources within the United States, as determined under the provisions of sections 861 through 864, for the 3-year period ending with the close of the taxable year of such individual or such corporation preceding the payment of such interest, or for such part of such period as may be applicable.

Section 1.861-2(c)(4) of the regulations provides that in making the determinations under section 861(a)(1)(B), (C), and (D) of the Code:

> (i) The gross income of a domestic corporation or a resident alien individual is to be determined by excluding any items specifically excluded from gross income under chapter 1 of the Code, and
>
> (ii) The gross income of a foreign corporation that is effectively connected with the conduct of a trade or business in the United States is to be determined under section 882(b)(2) and by excluding any items specifically excluded from gross income under chapter 1 of the Code, and
>
> (iii) The gross income from all sources of a foreign corporation is to be determined without regard to section 882(b) and without excluding any items otherwise specifically excluded from gross income under chapter 1 of the Code.

The equation used to determine whether less than 20 percent of gross income from all sources of a taxpayer has been derived from sources within the United States is based upon the provisions of section 861(a)(1)(B) of the Code and section 1.861-2(c)(4)(i) of the regulations. The equation is as follows:

$$\frac{\begin{array}{l}\text{U.S. sourced income less}\\ \text{Items specifically excluded}\\ \text{Under chapter 1 of the Code}\end{array}}{\begin{array}{l}\text{All Gross Income}\\ \text{Less items specifically excluded}\\ \text{Under chapter 1 of the Code}\end{array}} = \begin{array}{l}\text{Percentage of Gross income derived from sources within the United States}\end{array}$$

Inasmuch as *M* has income generated by the active conduct of a trade or business in Puerto Rico and has qualified for the benefits of section 931 of the Code, its gross income for Federal income tax purposes is only gross income from sources within the United States. However, in determining the denominator in the fraction in the above equation, it is necessary to include income specifically excluded under section 931 from business operations in Puerto Rico. Otherwise, the equation would render meaningless results and frustrate the purpose of section 931 inasmuch as the income would all be from sources within the United States. For example, assume that a possessions corporation received $100 from sales in the United States, $50 from interest on an obligation of state *X*, and $10,000 from its business operations in Puerto Rico. If, for purposes of section 861(a)(1)(B), the income from Puerto Rico is excluded from gross income in the denominator, the result would be that 100 percent of the possessions corporation's income would be from sources within the United States for the purpose of determining the source of interest paid by it.

Income from United States Source	$150
Less income excluded under chapter 1 of the Code (Section 103—Interest on Certain Government Obligations)	50
Gross income for purpose of computation	$100

The equation would be as follows:

$$\frac{\$100}{\$100} = 100\% \text{ income from sources within the United States}$$

Thus, interest paid by the possessions corporation would be from sources within the United States.

If income not included in the definition of gross income for the purpose of section 931 of the Code is included in the denominator of the above equation, the provisions of the Code are not frustrated. The interest paid by the possessions corporation would be from sources without the United States. The equation would be as follows:

United States sourced income	$ 100
Income from Puerto Rico	10,000
Gross income	$10,100

$$\frac{\$100}{\$10{,}100} = 1\% \text{ income from sources within the United States}$$

Accordingly, the interest payments received by *T* from *M* will be treated as income from sources without the United States under the provisions of section 861(a)(1)(B) of the Code because less than 20 percent of the gross income of *M* from all sources (including income not included in gross income under the provisions of section 931) has been derived from sources within the United States within the period of time specified therein.

Inasmuch as it has been determined that the interest paid by *M* is from sources without the United States, it is necessary to determine the actual geographic source of such interest in order to ascertain *T*'s qualification under section 931 of the Code.

Income from sources within a possession of the United States is to be determined under the provisions of section 1.863-6 of the regulations.

Section 1.863-1 of the regulations

provides, in part, that the principles applied in sections 1.861-1 to 1.863-5, inclusive, for determining the gross and the taxable income from sources within and without the United States shall generally be applied, for purposes of the income tax, in determining the gross and the taxable income from sources within and without a foreign country, or within and without a possession of the United States. In the application of section 1.863-6, the name of the particular foreign country or possession of the United States shall be substituted for the term "United States", and the term "domestic" shall be construed to mean created or organized in such foreign country or possession.

Section 1.931-1(a) of the regulations provides, in part, that, as used in section 931 of the Code, the phrase "possession of the United States" includes Puerto Rico when used with respect to a domestic corporation. That section further provides that this phrase does not include Puerto Rico when used with respect to citizens of the United States.

Therefore, for the purpose of determining income from sources within Puerto Rico with respect to the provisions of section 861 of the Code and the regulations thereunder, the term "Puerto Rico" shall be substituted for the term "United States" and a domestic corporation operating in Puerto Rico shall be deemed to be a foreign corporation with respect to Puerto Rico.

Section 861(a)(1)(C) and (D) of the Code is used to determine the source of interest received from a foreign corporation. Because these two subparagraphs are companion subparagraphs they are considered together in determining the source of interest paid by the possessions corporation in the instant case.

Section 861(a)(1)(C) of the Code provides that interest received from a foreign corporation (other than interest paid or credited by a domestic branch of a foreign corporation, if such branch is engaged in the commercial banking business) shall not be treated as income from sources within the United States when it is shown to the satisfaction of the Secretary or the Secretary's delegate that less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the payment of such interest (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States.

Section 861(a)(1)(D) of the Code provides that, in the case of interest received from a foreign corporation (other than interest paid or credited by a domestic branch of a foreign corporation, if such branch is engaged in the commercial banking business), 50 percent or more of the gross income of which from all sources for the 3-year period ending with the close of its taxable year preceding the payment of such interest (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States, an amount of such interest that bears the same ratio to such interest as the gross income of such foreign corporation for such period that was not effectively connected with the conduct of a trade or business within the United States bears to its gross income from all sources shall not be treated as income from sources within the United States.

Section 861(d)(1) of the Code provides, in part, that for purposes of section 861(a)(1)(B), (C), and (D), if the resident alien individual, domestic corporation, or foreign corporation, as the case may be, has no gross income from any source for the 3-year period (or part thereof) specified, the 20-percent test or the 50-percent test, as the case may be, shall be applied with respect to the taxable year of the payor in which payment of the interest is made.

Section 862(a)(1) of the Code provides that interest other than that derived from sources within the United States as provided in section 861(a)(1) shall be treated as income from sources without the United States.

The source of *M*'s interest payment is to be determined under the provisions of section 861(a)(1)(D) of the Code because in substituting the term "Puerto Rico" for the term "United States" and treating domestic corporation *M* as a foreign corporation to Puerto Rico, *M* has derived 50 percent or more of its gross income from Puerto Rico. Under the facts of the instant case 85 percent of *M*'s gross income was earned from business operations in Puerto Rico.

The equations for determining the source of the interest received from *M* are as follows:

1. Percent of gross income from sources without Puerto Rico

$$\frac{\text{Gross income not effectively connected with the conduct of a trade or business in Puerto Rico}}{\text{Gross income from all sources}} = \text{Percent of gross income from sources without Puerto Rico}$$

2. Interest sourced without Puerto Rico

$$\text{Percent of gross income from sources without Puerto Rico} \times \text{interest paid} = \text{interest sourced without Puerto Rico}$$

The operation of these equations can be illustrated by using the figures of the earlier example and by adding the additional fact that the possessions corporation paid $500 in interest during the year. Thus, we have $150 from sources within the United States that is not effectively connected with

the conduct of a trade or business in Puerto Rico inasmuch as it was received in the United States. The income from operations in Puerto Rico is $10,000. The numerator of the fraction is determined in accordance with the provisions of section 1.861-2(c)(4)(ii) of the regulations and the denominator is determined under section 1.861-2(c)(4)(iii). The numerical equations are as follows:

$$\frac{\$100.}{\$10{,}150.} = .01$$

$$.01 \times \$500. = \$5.$$

Therefore, $5. of interest paid by the possessions corporation in the above illustration is from sources without Puerto Rico.

Accordingly, in the instant case, pursuant to the principles of section 861(a)(1)(D) of the Code, the amount of the interest payments received by *T* from *M* to be treated as sourced without Puerto Rico is that part of such interest that bears the same ratio to such interest as the gross income of *M* that was not effectively connected with the conduct of a trade or business within Puerto Rico bears to its gross income from all sources. Inasmuch as 15 percent of *M*'s gross income was not effectively connected with the conduct of a trade or business within Puerto Rico, 85 percent of such interest payments received by *T* will be treated as income from sources within Puerto Rico for purposes of section 931 and 15 percent of such payments will be treated as income from sources without Puerto Rico.

Section 863.—Items Not Specified in Section 861 or 862

26 CFR 1.863-6: Income from sources within a foreign country or possession of the United States.

Whether interest is from sources within Puerto Rico. See Rev. Rul. 76-535, page 219.

Section 864.—Definitions

26 CFR 1.864-2: Trade or business within the United States.

Whether a foreign corporation may elect to treat a domestic corporate lessee as having acquired new section 38 property for investment credit purposes. See Rev. Rul. 76-515, page 14.

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26 CFR 1.864-4: U.S. source income effectively connected with U.S. business.

Whether a foreign currency board is engaged in a trade or business within the United States with respect to the acquisition of United States Government Treasury Bonds. See Rev. Rul. 76-329, page 223.

Part II.—Nonresident Aliens and Foreign Corporations
Subpart A.—Nonresident Alien Individuals

Section 871.—Tax on Nonresident Alien Individuals

26 CFR 1.871-1: Classification and manner of taxing alien individuals.

Rev. Rul. 76-283

Rev. Rul. 74-555, 1974-2 C.B. 202, incorrectly states in the fifth paragraph thereof, appearing on page 202, that section 861(a)(4) of the Code provides in relevant part that rentals or royalties for the use of or for the privilege of using copyrights in the United States shall be treated as income from sources without the United States. The phrase "from sources without the United States" is incorrect and should read "from sources within the United States." The Revenue Ruling incorrectly states in the sixth paragraph thereof, also appearing on page 202, that section 862(a)(3) of the Code provides that compensation for labor or personal services performed without the United States shall be treated as income from sources within the United States. The phrase "income from sources within the United States" is incorrect and is to be changed to read "income from sources without the United States."

Rev. Rul. 74-555 is modified to reflect the changes made above.

26 CFR 1.871-1: Classification and manner of taxing alien individuals.

Whether dividends received by limited partners, who are residents of Germany, shall be taxed at a rate of 30 percent. See Rev. Rul. 76-435, page 490.

Subpart B.—Foreign Corporation

Section 881.—Tax on Income of Foreign Corporations Not Connected With United States Business

26 CFR 1.881-1: Manner of taxing foreign corporations.

Whether the gross income of a domestic corporation, the assets of which were acquired in a statutory merger, should be taken into account by the surviving corporation with respect to pre-merger years, in applying the source of income tests of section 861(a)(1)(B) and section 861(a)(2)(A) of the Code. See Rev. Rul. 76-300, page 217.

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26 CFR 1.881-2: Taxation of foreign corporations not engaged in U.S. business.

Whether a Belgian private foundation is subject to the excise tax imposed by section 4948(a) of the Code on its investment income when the United States-Belgium Income Tax Convention reduces the normal 30 percent withholding rate on such income to 15 percent. See Rev. Rul. 76-330, page 488.

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26 CFR 1.881-2: Taxation of foreign corporations not engaged in U.S. business.

Whether a foreign corporation may elect to treat a domestic corporate lessee as having acquired new section 38 property for investment credit purposes. See Rev. Rul. 76-515, page 14.

Section 882.—Tax on Income of Foreign Corporations Connected with United States Business

26 CFR 1.882-1: Taxation of foreign corporations engaged in U.S. business or of foreign corporations treated as having effectively connected income.

Whether a disposition of property occurs when an oil rig is moved outside the taxing jurisdiction of the United States. See Rev. Rul. 76-339, page 251.

Subpart C.—Miscellaneous Provisions

Section 892.—Income of Foreign Governments and of International Organizations

26 CFR 1.892-1: Income of foreign governments and international organizations.
(Also Sections 864, 895; 1.864-4, 1.895-1.)

Exemption; foreign Currency Board. A Currency Board, created by the government of a foreign country to issue and redeem the currency of that country, that meets all the requirements of Rev. Rul. 75-298 is not engaged in commercial banking functions or other commercial activities within the U.S. with respect to its acquisition of U.S. Government Treasury Bonds and is exempt from Federal taxation received from its investments in these bonds under section 892 of the Code as well as section 895.

Rev. Rul. 76-329

Advice has been requested whether, under the circumstances described below, an organization created by a foreign government for the purpose of issuing legal tender notes and coins in that foreign country is exempt from Federal income tax under the provisions of section 892 of the Internal Revenue Code of 1954, on the interest received from its investments in United States Government Treasury Bonds.

Foreign country *X* enacted legislation in 1974 to create a Currency Board. The Currency Board was established for the purpose of issuing and redeeming country *X* currency. The law that created the Currency Board, provides that the Currency Board has the sole right to issue legal tender notes and coins of country *X*. The Currency Board is to establish a Currency Fund to receive all amounts due to and payable by the Board under the provisions of the law. The Currency Board is permitted to buy and sell securities of or guaranteed by the Government of the United States. The United States securities purchased by the Currency Board form part of the reserve for country *X* currency in circulation.

During 1974, the Currency Board acquired United States Treasury Bonds that resulted in interest income for that year.

The Government of country *X* certified to the Internal Revenue Service that: (1) The Currency Board is wholly owned and controlled by the Government of *X*; (2) The Currency Board's assets and income are derived solely from its activities and investments and from the Government of country *X*; (3) The Board's net income is credited either to itself or to the Government of country *X*, with no portion of its income inuring to the benefit of any private person; and (4) The Currency Board's investments in the United States include only currencies, fixed interest deposits, stock, bonds, notes, and certain other securities evidencing loans. This certification was made by the Government of country *X* in accordance with the provisions of Rev. Rul. 75-298, 1975-2 C.B. 290.

Rev. Rul. 75-298 holds, in part, that income earned by a foreign bank that qualifies as a central bank of issue under section 895 of the Code, or by any other organization created by a foreign government that does not engage in the United States in either commercial banking functions as described in section 1.864-4(c)(5)(i) of the Income Tax Regulations or in other commercial activities (on more than a de minimis basis in the United States) qualifies for an exemption from Federal income tax as described in section 892, provided that the foreign government certifies that such bank or other organization meets the following requirements:

1. It is wholly owned and controlled by a foreign government;

2. Its assets and income are derived solely from its activities and investments and from the foreign government;

3. Its net income is credited either to itself or to the foreign government, with no portion of its income inuring to the benefit of any private person; and

4. Its investments in the United States, if any, include only those which produce passive income, such as currencies, fixed interest deposits, stocks, bonds, and notes or other securities evidencing loans.

Section 892 of the Code provides, in part, that income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments shall not be included in gross income and shall be exempt from Federal income taxation.

Section 895 of the Code provides, in part, that income derived by a foreign central bank of issue from obligations of the United States or any other agency or instrumentality thereof that are owned by such foreign central bank of issue, or derived from interest on deposits with persons carrying on the banking business, shall not be included in gross income and shall be exempt from taxation. However, section 895 provides further that such income will not be exempt from taxation if such obligations or deposits are held for, or used in connection with, the conduct of commercial banking functions or other commercial activities.

Section 1.895-1(b) of the regulations defines a foreign central bank of issue as a bank that is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency.

Section 1.864-4(c)(5)(i) of the regulations provides, in part, that a foreign corporation shall be considered to be engaged in the active conduct of banking if at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of any one or more of the following

activities carried on, in whole or in part, in the United States in transactions with persons situated within or without the United States: (a) receiving deposits of funds from the public; (b) making personal, mortgage, industrial, or other loans to the public; (c) purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness; (d) issuing letters of credit to the public and negotiating drafts drawn thereunder; (e) providing trust services for the public; or (f) financing foreign exchange transactions for the public.

In the instant case, the interest income of the Currency Board from United States Treasury Bonds qualifies for exemption from taxation pursuant to section 895 of the Code because the bonds that it has invested are not used in connection with the conduct of commercial banking functions or other commercial activities. However, it also qualifies for the broader exemption from taxation pursuant to section 892 because it met the requirements set forth in Rev. Rul. 75-298.

Accordingly, the Currency Board is a central bank of issue not engaged in the United States in either commercial banking functions or other commercial activities as described in section 1.864-4(c)(5)(i) of the regulations. It is further held that the Currency Board is exempt from Federal income taxation under section 892 of the Code.

Section 894.—Income Affected By Treaty

26 CFR 1.894-1: Income affected by treaty.

Whether a Belgian private foundation is subject to the excise tax imposed by section 4948(a) of the Code on its investment income when (1) the United States-Belgium Income Tax Convention reduces the normal 30 percent withholding rate on such income to 15 percent and (2) the Friendship, Establishment, and Navigation Treaty with Belgium prohibits the United States from taxing Belgian companies at rates more burdensome than those imposed on third country nationals. See Rev. Rul. 76-330, page 488.

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26 CFR 1.894-1: Income affected by treaty.

Whether amounts paid to a Japanese resident for doing research within the U.S. are exempt from Federal income tax under Article 20 of the U.S.-Japan Income Tax Convention. See Rev. Rul. 76-567, page 491.

Section 895.—Income Derived By A Foreign Central Bank of Issue From Obligations of the United States Or From Bank Deposits

26 CFR 1.895-1: Income derived by a foreign central bank of issue, or by Bank for International Settlements, from obligations of the United States or from bank deposits.

Whether a foreign currency board is a foreign central bank for Federal income tax purposes. See Rev. Rul. 76-329, page 223.

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26 CFR 1.895-1: Income derived by a foreign central bank of issue, or by Bank for International Settlements, from obligations of the United States or from bank deposits.

Tax treatment of certain debentures issued by small business investment companies and guaranteed by the Small Business Administration. See Rev. Rul. 76-426, page 17.

Part III.—Income From Sources Without the United States
Subpart A.—Foreign Tax Credit

Section 901.—Taxes of Foreign Countries and of Possessions of United States

26 CFR 1.901-1: Allowance of credit for taxes.

Foreign tax credit; Irish Wealth Tax. Tax imposed by the Irish Wealth Tax Act of 1975 is not an income tax for which credit is allowable under section 901 of the Code.

Rev. Rul. 76-536

Advice has been requested whether tax imposed by the Irish Wealth Tax Act of 1975 (Act) is an income tax for which credit is allowable under section 901 of the Internal Revenue Code of 1954.

The taxpayer is a United States citizen residing in Ireland. The taxpayer is, pursuant to the Act, subject to tax on worldwide wealth. The Act imposes a flat rate of tax on the net market value of taxable wealth less allowable exclusions. Taxable wealth, as defined by the Act, is basically the net value of all the property to which the taxpayer is beneficially entitled in possession. The net market value of taxable wealth is arrived at by reducing the market value by the debts and encumbrances attributable to such property.

Section 901(a) of the Code provides, in part, that if the taxpayer chooses to have the benefits of subpart A of chapter 1, the tax imposed by chapter 1 shall, subject to the applicable limitations of section 904, be credited with the amounts provided in the applicable paragraph of section 901(b).

Section 901(b) of the Code provides, in part, that, subject to the applicable limitations of section 904, in the case of a citizen of the United States, the amount of any income tax paid or accrued during the taxable year to any foreign country shall be allowed as a credit under section 901(a).

Whether a foreign tax can be considered an income tax for purposes of section 901 of the Code is based on whether such tax is considered an income tax under United States standards thereof. *Biddle v. Commissioner,* 302 U.S. 573 (1938), 1938-1 C.B. 309. The Act levies a tax on the taxpayer's holdings of property, as opposed to his income.

Accordingly, the amount of tax paid to the Government of Ireland pursuant to the Act is not an income tax within the United States concept thereof, and is not a creditable tax for purposes of section 901 of the Code.

Section 902.—Credit for Corporate Stockholder in Foreign Corporation

26 CFR 1.902-3: Credit for domestic corporate shareholder of a foreign corporation (after amendment by Revenue Act of 1962).
(Also Section 482; 1.482-1.)

Foreign tax credit; income allocation to domestic parent. The allocation of income from a foreign subsidiary, in a country with which the U.S. has an income tax convention, to its domestic parent under section 482 of the Code reduces the amount of the foreign tax paid by the subsidiary to be used in computing the parent's deemed paid foreign tax credit under section 902 in the absence of efforts by both the subsidiary, to seek reduction of its foreign income tax liability, and the domestic parent, to secure competent authority consideration; Rev. Rul. 74-158 clarified.

Rev. Rul. 76-508 [1]

Advice has been requested whether, in a situation where income is allocated from a foreign subsidiary corporation to its domestic parent corporation under section 482 of the Internal Revenue Code of 1954, the Internal Revenue Service can reduce the amount of the foreign tax paid by that foreign subsidiary to be used in computing the parent's deemed paid foreign tax credit under section 902.

P, a domestic corporation, owns all of the outstanding capital stock of *S*, a foreign corporation organized under the laws of foreign country *Z*. *S* is not a less developed country corporation within the meaning of section 955(c)(3) of the Code. Both corporations use the calendar year as their taxable year.

In 1973, *P* made sales of its products to *S* at a price below *P*'s cost. In 1975, the Service proposed an allocation of income under section 482 of the Code for 1973 to reflect an arm's length selling price. For 1973, *S* had paid a country *Z* income tax on reported income for $30x$ dollars. Pursuant to the allocation of income under section 482, *S*'s country *Z* income was reduced by $10x$ dollars and *P*'s income was increased by the same amount.

P received a dividend from *S* during 1973 out of its 1973 earnings and profits and claimed a deemed paid foreign tax credit under section 902 of the Code based on the amount of country *Z* taxes paid by *S* in 1973 before the allocation. *S* did not seek a refund of its country *Z* tax attributable to its income allocated to *P* under section 482.

The United States has a tax treaty in force in country *Z* that provides for consideration between the Competent Authority of the United States and the Competent Authority of country *Z*. Rev. Proc. 70-18, 1970-2 C.B. 493, sets forth procedures for United States persons to obtain competent authority consideration where the United States or a foreign treaty country proposes or has made an allocation of income and deductions among related parties. *P* did not request competent authority assistance to coordinate the amount of income tax due to country *Z* and the United States as a result of the adjustment made under section 482 of the Code.

Section 482 of the Code provides, in part, that in any case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary of the Treasury or the Secretary's delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if the Secretary or the Secretary's delegate 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.

Section 901 of the Code allows a credit against United States income tax of certain taxpayers for foreign income, war profits, and excess profits taxes paid or accrued or deemed to have been paid or accrued within the taxable year.

Section 902(a)(1) of the Code provides, in general, that a domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year that were paid out of accumulated profits shall be deemed to have paid a certain portion of any creditable income tax paid or deemed to have been paid by such foreign corporation to any foreign country or to any possession of the United States on or with respect to such accumulated profits.

The effect of an allocation under section 482 of the Code on the computation of the deemed paid credit is explained in Rev. Rul. 74-158, 1974-1 C.B. 182. Rev. Rul. 74-158 states as a fact that the income taxes of the subsidiary were not changed by the allocation under section 482; thus, the question raised in the instant case did not arise in Rev. Rul. 74-158.

Rev. Rul. 74-158 holds that the foreign income taxes deemed paid under section 902(a)(1) of the Code shall be determined in accordance with the following formula:

$$\frac{\text{Dividends (without regard to section 78)}}{\text{Accumulated profits (as defined in section 902(c)(1)(A) in excess of income taxes paid)}} \times \text{Foreign income taxes} = \text{Foreign income taxes deemed paid}$$

The statutory language of section 901 of the Code permits a domestic corporation a credit for the foreign income taxes it pays, including foreign

[1] Also released as News Release IR-1703, dated December 2, 1976.

income taxes it is deemed to have paid under section 902. Section 902(a)(1) does not authorize a domestic corporation to claim a credit for all payments made by its foreign subsidiary to a foreign country. Instead, it merely provides the proper method for computing what portion of the payment may be credited if the payment otherwise qualifies as an "income tax" under section 901. In order for a tax paid to a foreign country to qualify as an income tax, however, it must be shown that the tax imposed by the foreign country is a tax on income within the United States concept thereof. *Biddle v. Commissioner,* 302 U.S. 573 (1938), 1938-1 C.B. 309.

If a taxpayer is put on notice, whether by a proposed adjustment by the Service under section 482 of the Code or otherwise, of the possibility of securing a refund or reduction of foreign income tax liability but fails to pursue its remedies to secure such an adjustment the amounts as to which an adjustment was not sought may be contributions to the foreign government. See *Kenyon Instrument Co.,* 16 T.C. 732 (1951), which held that state franchise taxes were not deductible to the extent that at the time of payment the taxpayer knew that it was not liable to pay them. *See also* section 1.901-2(a) of the Income Tax Regulations.

When as in the instant case income is allocated to a domestic corporation from its foreign subsidiary under section 482 of the Code, a presumption arises that the subsidiary has made a contribution to the foreign government. This presumption will be rebutted if the subsidiary exhausts all effective and practicable administrative remedies in seeking a refund of its foreign income tax liability and if the domestic parent exhausts its rights under the competent authority procedure pursuant to station 5 of Rev. Proc. 70-18.

Accordingly, since both *P* and *S* failed to exhaust their respective administrative remedies in seeking readjustment of *S*'s country *Z* income tax liability, the reduction is *S*'s income pursuant to an allocation of income under section 482 of the Code will result in the reduction of the amount of country *Z* taxes paid by *S* for 1973 that qualify for use by *P* in computing the deemed paid foreign tax credit under section 902(a)(1).

In computing the deemed paid foreign tax credit, *P* is to use the foreign income tax as recomputed as the multiplicand in the section 902 fraction set forth above. The multiplicand to be use may be determined as follows:

(1) The foreign tax liability recomputed by country *Z* under its law as a result of the allocation under section 482 may be used as the multiplicand.

(2) Absent a recomputation of the foreign tax liability by country *Z*, if *P* can establish to the satisfaction of the District Director of Internal Revenue with whom *P* files its return what the proper amount of foreign tax liability should be under the laws of country *Z* after the allocation under section 482, such amount will then be utilized for purposes of the multiplicand in the section 902 fraction.

(3) Absent a recomputation of the foreign tax liability by country *Z*, if *P* cannot establish to the satisfaction of the District Director what the proper amount of foreign tax liability should be under the laws of country *Z* after the above allocation, then the District Director may adjust the section 902 formula by an appropriate amount of non-tax payments, such as by recomputing the amount of taxes used in the multiplicand of the section 902 fraction by applying the ratio that the amount of the section 482 adjustment bears to *S*'s total gross income.

Further, for the purposes of determining the foreign tax liability to country *Z*, the United States Competent Authority may, at its option, consult with the Competent Authority of country *Z* pursuant to the applicable treaty provision.

Rev. Rul. 74-158 is clarified. The conclusion contained therein that the income taxes of the subsidiary were not changed by the allocation under section 482 is meant to reflect no change in the foreign taxes paid by the foreign subsidiary upon recomputation by country *Y* under alternative (1) above. Under the facts of Rev. Rul. 74-158 there was no tax treaty in force with country *Y*; thus, the competent authority procedure could not be invoked.

Subpart B.—Earned Income of Citizens of United States

Section 911.—Earned Income From Sources Without the United States

26 CFR 1.911-1: Earned income from sources without the United States attributable to services performed before 1963.

Whether compensation received for personal services rendered in a foreign country by a citizen and resident of that country who later became a United States resident is earned income for purposes of the retirement income credit. See Rev. Rul. 76-295, page 5.

Section 911.—Earned Income From Sources Without the United States

26 CFR 1.911-2: Earned income from sources without the United States attributable to services performed after 1962.

Income source; customs inspector's overtime reimbursed by airline. Overtime pay received from the U.S. Government by a customs inspector at a pre-clearance station in a foreign country, for services outside of designated working hours requested by airlines that reimburse the U.S. for the costs incurred, is an amount paid by the U.S. or an agency thereof and is not excludable from gross income under section 911 of the Code.

Rev. Rul. 76-321

Advice has been requested whether, under the circumstances described below, certain payments for overtime services are excludable from a taxpayer's gross income under section 911(a) of the Internal Revenue Code of 1954.

The taxpayer, a United States citizen, is an employee of the United States Customs Service (Customs Service) who performed services throughout 1975 as a customs inspector at a Customs Service pre-clearance station in country *X*. The purpose of this pre-clearance station is to expedite the United States customs clearance of passengers and baggage for entry into the United States.

The administrative costs of the Customs Service pre-clearance station in country *X*, and any overtime payments made to Customs Service employees for their services performed outside of designated working hours, are reimbursable by the various airline carriers requesting such services. Airline carriers utilizing pre-clearance stations and requiring Customs Service overtime services, outside of the normal prescribed working hours, are required to apply for a license and furnish adequate bond to insure indemnification of these reimbursable expenses. Moreover, such carriers must furnish in advance to Customs Service officials the time of departure of the aircraft and the estimated number of overtime hours needed for any pre-clearance inspection of the carrier's passengers and baggage for entry into the United States.

Overtime compensation earned by Customs Service employees is payable by the United States and is not contingent upon a carrier's ability to repay or the timing of the overtime reimbursement to the United States. The Customs Service bills each carrier on a bi-weekly basis for its portion of the overtime costs incurred and paid for providing pre-clearance inspections.

During 1975 the taxpayer received certain amounts as overtime compensation for work performed at the pre-clearance station in country *X*. The taxpayer was under the control and jurisdiction of the Customs Service and was not an employee of the carriers during these overtime periods.

Subject to certain conditions and limitations, section 911(a) of the Code allows an individual United States citizen employed abroad who is either a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year (section 911(a)(1)) or present in a foreign country or countries for 510 days during a period of 18 consecutive months (section 911(a)(2)), to exclude from gross income amounts received from sources without the United States (except amounts paid by the United States or an agency thereof) that constitute earned income (as defined in section 911(b)) attributable to services performed during such period.

The specific issue is whether the payments for overtime services received by the taxpayer in 1975 are amounts paid by the United States or an agency thereof within the meaning of section 911(a) of the Code.

The statute upon which section 24.16, Title 19 of the Code of Federal Regulations (1975) is based provides for the reimbursement to the Customs Service by the airline carriers. That statute was discussed in the case of *Port Huron & Sarnia Ferry Co. v. Lawson,* 292 F. 216 (E.D. Mich. 1923). In that case the court stated:

> Under the terms of the statute, the compensation for such overtime service is not paid by the licensee to such officers or employees, but to the collector of customs, who pays the extra compensation, which has been fixed by the Secretary of the Treasury, to those entitled thereto, according to the rate so fixed. In substance and essence the recipient of the special license so granted indemnifies and reimburses the government for the additional liability and expense incurred by it by reason of the extra cost of granting this special license. The customs officials performing the overtime services required are employed by, and look for payment of their compensation to, the government, which, in turn, is thus reimbursed, and saved harmless by the licensee. This does not render the purpose of the payment a private benefit, and Congress is well within its constitutional powers in making provision for such a transaction.

Rev. Rul. 58-485, 1958-2 C.B. 388, involves the issue of whether compensation received by a United States citizen, as an employee of an agency of the United States, for services performed in a foreign country on assignment to the government of such foreign country, is excludable from such citizen's gross income under section 911(a)(2) of the Code, where the foreign country reimbursed the United States agency for the cost of such employee's salary. That Revenue Ruling holds that the status of the taxpayer as an employee of an agency of the United States was not affected by the taxpayer's assignment to the foreign government and that the compensation was an amount paid by the United States within the meaning of section 911(a). Moreover, Rev. Rul. 58-485 states that the transfer of funds from the foreign government to the United States to reimburse the United States agency for the cost of salaries paid to its employees assigned to the foreign government does not operate to constitute the foreign government furnishing such funds the payor of the taxpayer's salary.

In the instant case the taxpayer was an employee of a United States agency during the periods in which the taxpayer earned overtime compensation. Moreover, the fact that the airline carriers reimbursed the Customs Service for the taxpayer's overtime compensation does not change the fact that a United States agency had the primary legal obligation to compensate the taxpayer.

Accordingly, the payments for overtime services received by the taxpayer in 1975 are amounts paid by the United States or an agency thereof within the meaning of section 911(a) of the Code. Therefore, such payments are not excludable from the

taxpayer's gross income under section 911(a).

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26 CFR 1.911-2: Earned income from sources without the United States attributable to services performed after 1962.

Whether compensation received for personal services rendered in a foreign country by a citizen and resident of that country who later became a United States resident is earned income for purposes of the retirement income credit. See Rev. Rul. 76-295, page 5.

Subpart C.—Western Hemisphere Trade Corporations

Section 922.—Special Deduction

26 CFR 1.922-1: Special deduction of Western Hemisphere trade corporation.

Western Hemisphere trade corporation; indirect ownership of DISC. Ownership of a DISC by an individual who is also the sole owner of a corporation, otherwise qualifying as a Western Hemisphere trade corporation, does not constitute indirect ownership of DISC stock by the corporation, and the special deduction provided in section 922 of the Code is allowable to the Western Hemisphere trade corporation.

Rev. Rul. 76-537

Advice has been requested as to whether the special deduction provided by section 922 of the Internal Revenue Code of 1954 is allowable to a Western Hemisphere Trade Corporation under the circumstances described below.

Taxpayer, a domestic corporation, meets all of the requirements for a "Western Hemisphere trade corporation" (WHTC), as that term is defined in section 921 of the Code. Taxpayer is wholly owned by *A*, an individual. *A* is also the sole owner of *M*, a domestic international sales corporation (DISC).

Section 922 of the Code provides for a special deduction in computing the taxable income of a WHTC. However, section 922 further provides that the special deduction shall not be allowed to a corporation for a taxable year for which it is a DISC or in which it owns at any time stock in a DISC or former DISC (both as defined in section 992(a)).

Section 1.922-1(c) of the Income Tax Regulations provides, in part, that the special deduction provided by section 922 is not allowable to a corporation for a taxable year during which it owns directly or *indirectly* at any time stock in a corporation which, at such time, is (or is treated as) a DISC or former DISC. (Emphasis added.)

The specific question is whether ownership by the same person, *A*, of all the stock of both the WHTC and the DISC is considered indirect ownership of DISC stock by the WHTC, within the meaning of section 1.922-1(c) of the regulations.

The provision in section 922 of the Code that the special deduction for a WHTC will not apply to a corporation that is a DISC or owns DISC stock was enacted by the Revenue Act of 1971, section 502(c), 1972-1 C.B. 443, 475. The purpose of this provision, as explained in the Congressional committee reports, is to prevent a corporation that otherwise qualifies as a WHTC from receiving in the same taxable year, the double benefits of DISC treatment and WHTC treatment. With respect to a WHTC, the Congressional Committee reports provide, "It would be inappropriate to accord tax-deferred status to a DISC's profits when earned by the DISC and, in addition, the special Western Hemisphere trade corporation tax rates on those profits when they are distributed by the DISC." *S. Rep. No. 92-437*, 92nd Cong., 1st Sess. 125 (1971), 1972-1 C.B. 559, 629; *H. Rep. No. 92-533*, 92nd Cong., 1st Sess. 91 (1971), 1972-1 C.B. 498, 547.

The foregoing indicates that Congress was concerned with preventing profits that were not taxed when earned by a DISC from also receiving the benefit of the lower rate of tax applicable to a WHTC when received by the WHTC. Section 1.922-1(c) of the regulations is intended to prevent this type of double benefit when a WHTC owns DISC stock directly as well as when a WHTC indirectly owns DISC stock. Therefore, the term "indirectly" was included in section 1.922-1(c). Without such inclusion, it would be possible for a WHTC to own all the stock of a first-tier corporation whose sole function is to hold the stock of a second-tier subsidiary which is a DISC. Such an arrangement could provide a vehicle by which Congressional intent would be circumvented at the point when the profits of the DISC, after distribution to the first-tier corporation are distributed to the WHTC.

The instant case involves an individual that owns both a WHTC and a DISC. This type of stock ownership will not result in affording the double benefit that the Congressional committee reports discuss and consequently is not the type of indirect stock ownership that section 1.922-1(c) of the regulations refers to in precluding the special deduction provided by section 922 of the Code. The Congressional committee reports and regulations relate to the possible double benefit to a WHTC, rather than to its owner.

Accordingly, since the taxpayer meets the requirements for a WHTC as provided by section 921 of the Code, and is not precluded from the special deduction by reason of *A*'s ownership of *M*, a DISC, the special deduction provided by section 922 is allowable to the taxpayer.

Subpart D.—Possessions of the United States

Section 931.—Income From Sources Within Possessions of the United States

26 CFR 1.931-1: Citizens of the United States and domestic corporations deriving

income from sources within a possession of the United States.

Whether interest is from sources within Puerto Rico. See Rev. Rul. 76-535, page 219.

Subpart F.—Controlled Foreign Corporations

Section 951.—Amounts Included in Gross Income of United States Shareholders

26 CFR 1.951-1: Amounts included in gross income of United States shareholders. (Also Sections 542, 956, 964; 1.542-1, 1.956-1, 1.964-1.)

Controlled foreign corporations; income includible by domestic parent. The amount includible in the gross income of a domestic corporation, whose controlled foreign corporations had an increase in earnings invested in U.S. property, retains the character it had when realized by the controlled foreign corporations for purposes of determining whether the domestic corporation is a personal holding company.

Rev. Rul. 76-403

Advice has been requested whether, under the circumstances described below, the amount includible in the gross income of a domestic corporation under section 951(a)(1)(B) of the Internal Revenue Code of 1954, retains the charatcer it had when realized by its controlled foreign corporations, for purposes of determining whether the domestic corporation is a personal holding company under section 542 and the regulations thereunder.

The taxpayer is a domestic corporation owning 100 percent of the stock of three foreign corporations all of which derive their income in the form of commissions from the sale or resale of real estate as commission brokers. The taxpayer does not carry on an active business itself and prior to 1975 reported only interest income generated from outstanding loans. The taxpayer and the three foreign corporations are all calendar year taxpayers.

In 1975 there was an increase in earnings invested in United States property, within the meaning of section 951(a)(1)(B) of the Code, by the foreign corporations. The investments consisted of obligations of United States persons within the meaning of section 956(b)(1)(C) and the regulations thereunder.

Section 1.951-1(a)(2) of the Income Tax Regulations provides, in part, that for purposes of determining whether a United States shareholder that is a domestic corporation is a personal holding company under section 542 of the Code and section 1.542-1, the character of the amount includible in the gross income of such domestic corporation under section 951 shall be determined as if such amount were realized directly by such corporation from the source from which it is realized by the controlled foreign corporation.

The concept expressed in section 1.951-1(a)(2) of the regulations is referred to as the "character-of-amount-pass-through concept." If the amount includible in the gross income of the United States shareholder that is a domestic corporation is attributable to, for example, sales or commission income, then this amount shall be treated as income from sales or commissions and not as a dividend for the purpose of determining whether the subject domestic corporation is a personal holding company under section 542 of the Code.

In determining whether the domestic corporation, as the United States shareholder, is a personal holding company under section 542 of the Code, the amount included in income under section 951(a) is, pursuant to the character-of-amount-pass-through concept, personal holding income only if the underlying income items would be personal holding company income to the controlled foreign corporation. However, unlike section 951(a)(1)(A), which refers to "subpart F income" that is specifically characterized in section 952, section 951(a)(1)(B) refers only to amounts invested in United States property without any indication as to the character of such amounts. Therefore, in the case of section 951(a)(1)(B) amounts, it is necessary to determine the character of the controlled foreign corporation's earnings and profits that enable such corporation to increase the amount of its earnings invested in United States property.

It is the burden of the taxpayer to establish the character of the foreign corporation's earnings and profits. If it cannot be established, the increase for any taxable year in the earnings and profits invested in United States property, within the scope of section 956 of the Code, will be considered for purposes of section 1.951-1(a)(2) of the regulations to be foreign personal holding company income and the section 542 determination will be made accordingly. Sections 1.964-3 and 1.964-4 specifically refer to the responsibility of the United States shareholder to provide sufficient books and records for the purpose of verifying its income tax liability with respect to amounts includible in income under section 951. In this regard sections 1.964-3(b), 1.964-4(b), and 1.964-4(d) specifically list the classes of income that must be established by these books and records. Therefore, if such books and records are maintained, as required, the controlled foreign corporation's earnings and profits can be characterized therefrom for the purpose of applying the character-of-amount-pass-through concept under the language of section 1.951-1.

Accordingly, in the instant case, the amount includible in the gross income of the taxpayer in 1975 under section 951 of the Code retains the character it had when realized by the controlled foreign corporations for the purpose of determining whether the taxpayer is a personal holding company under sec-

tion 542 and the regulations thereunder. This character-of-amount-pass-through concept applies also to the three foreign corporations' increase in earnings invested in United States property, as determined under section 956(a), by determining the character of such corporations' earnings and profits that enabled such corporations to increase the amount of their earnings invested in United States property.

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26 CFR 1.951-1: Amounts included in gross income of United States shareholders.

Whether an amount taxed to a shareholder of a controlled foreign corporation as subpart F income under section 951(a)(1)(A)(i) of the Code, and invested in U.S. property, can represent an increase in earnings invested in U.S. property for purposes of section 951(a)(1)(B). See Rev. Rul. 76-538, this page.

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26 CFR 1.951-1: Amounts included in gross income of United States shareholders.

Whether the basis of a U.S. shareholder's stock in its wholly owned controlled foreign corporation is reduced under section 961 of the Code by the amount of the controlled foreign corporation's increase in earnings invested in U.S. property excluded from the shareholder's gross income with respect to the controlled foreign corporation pursuant to section 959(a)(2). See Rev. Rul. 76-539, page 232.

Section 952.—Subpart F Income Defined

26 CFR 1.952-1: Subpart F income defined.

Whether an amount taxed to a shareholder of a controlled foreign corporation as subpart F income under section 951(a)(1)(A)(i) of the Code, and invested in U.S. property, can represent an increase in earnings invested in U.S. property for purposes of section 951(a)(1)(B). See Rev. Rul. 76-538, below.

Section 956.—Investment of Earnings in United States Property

26 CFR 1.956-1: Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.
(Also Sections 951, 952, 959; 1.951-1, 1.952-1, 1.959-1.)

Controlled foreign corporation; U.S. investments; subpart F income. Income earned and invested in U.S. property by a wholly owned controlled foreign corporation and taxed to the parent as subpart F income represents an increase in earnings invested in U.S. property for purposes of section 956 of the Code, but section 959(a)(2) prevents such an increase from being again included in the parent's income as income from an increase in investment in U.S. property.

Rev. Rul. 76-538

Advice has been requested concerning the Federal income taxation under section 951(a)(1)(B) of the Internal Revenue Code of 1954 of an increase in earnings invested in United States property under the circumstances described below.

P is a domestic corporation engaged in a trade or business and *S* is a wholly owned controlled foreign corporation (CFC) of *P* organized in country *M*.

In 1974, *S* realized no earnings from its operations and invested no earnings in United States property. In 1975, *S* realized earnings of $100x$ dollars that were subpart F income included in *P*'s gross income pursuant to section 951(a)(1)(A)(i) of the Code. Such amount was invested by *S* during 1975 in United States property as defined in section 956(b).

The specific questions presented are: (1) whether *S*'s $100x$ dollars of earnings in 1975, taxed to *P* as subpart F income, also represent a $100x$ dollar increase in earnings invested in United States property for 1975 and, (2) whether such increase is taxable to *P* under section 951(a)(1)(B) of the Code.

Section 951(a)(1) of the Code, as in effect for taxable years beginning before December 31, 1975, provides, in part, that if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year beginning after December 31, 1962, every person who is a United States shareholder of such corporation and who owns stock in such corporation on the last day in such year on which such corporation is a controlled foreign corporation shall include in gross income, for such person's taxable year in which or with which such taxable year of the corporation ends,—

(A) the sum of—
(i) such person's pro rata share of the corporation's subpart F income for such year and
(ii) * * *; and
(B) such person's pro rata share of the corporation's increase in earnings invested in United States property for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

Section 956(a)(1) of the Code provides, in part, that the amount of earnings of a CFC invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the CFC at the close of the taxable year, to the extent such amount would have constituted a dividend if it had been distributed.

Section 956(a)(2) of the Code provides, in part, that in the case of any United States shareholder, the pro rata share of the increase for any taxable year in the earnings of a CFC invested in United States property is the amount determined by subtracting the shareholder's pro rata share of:

(A) the amount of earnings of the CFC invested in United States property at the close of the preceding taxable year from

(B) the amount of earnings of the CFC invested in United States property at the close of the taxable year.

Section 956(b) of the Code defines the term "United States property."

Section 959(d) of the Code provides, in part, that any distribution excluded from gross income under section 959(a) (because previously taxed under section 951(a)) shall be treated as a distribution that is not a dividend.

Section 1.956-1(b)(1) of the Income Tax Regulations provides, in part, that for purposes of determining the amount of the CFC's earnings in-

vested at the close of its taxable year in United States property, the determination of whether an amount would have constituted a dividend if distributed shall be made without regard to the provisions of section 959(d) of the Code.

Consequently, the fact that *S*'s 100*x* dollars of earnings in 1975 were taxed to *P* as subpart F income, and if distributed would not have been included in *P*'s income as a dividend by reason of section 959(d) of the Code, does not prevent such amount from being treated as earnings invested in United States property.

In addition, section 1.956-1(b)(2) of the regulations provides, in part, that for purposes of determining whether an amount of investment would have constituted a dividend if distributed at the close of any taxable year of a CFC, earnings and profits of the CFC shall be considered not to include any amounts that are attributable to:

(i) Amounts which have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(B) (or which would have been so included but for section 959(a)(2)) and have not been distributed, or

(ii)(a) Amounts which are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(b) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

Since section 1.956-1(b)(2) of the regulations does not exclude amounts included under section 951(a)(1)(A) of the Code in the income of a United States shareholder of a CFC, such amounts are included in determining the amount of a CFC's investment in United States property at the close of its taxable year.

Accordingly, *S*'s 100*x* dollars of earnings invested in United States property in 1975, taxed to *P* as subpart F income, also represents a 100*x* dollar increase in earnings invested in United States property in 1975 for purposes of section 956 of the Code.

Section 1.956-1(b)(2) of the regulations provides, however, that the rules of that section apply only in determining the limitation on a CFC's increase in earnings invested in United States property and makes references to section 959 of the Code and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

Section 959(a)(2) of the Code provides, in part, that the earnings and profits for a taxable year of a foreign corporation attributable to amounts that are, or have been included in the gross income of a United States shareholder under section 951(a) shall not, when such amounts would, but for section 959(a) be included under section 951(a)(1)(B) in the gross income of such United States shareholder be again included in the gross income of such shareholder.

In the instant case, the 100*x* dollars invested in United States property is an increase of 100*x* dollars of *S*'s earnings invested in United States property over the amount invested in 1974 since *S* invested no earnings in United States property in 1974. Although such amount would normally be included in the income of *P* under section 951(a)(1)(B) of the Code, section 959(a)(2) prevents such inclusion since the 100*x* dollars have already been included in *P*'s income under section 951(a)(1)(A)(i) as subpart F income.

For a consideration of basis determination under section 961 of the Code and the computation of earnings and profits under section 1248, see Rev. Rul. 76-539, page 232, this Bulletin.

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26 CFR 1.956-1: Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

Whether the amount includible in the gross income of a domestic corporation under section 951(a)(1)(B) of the Code retains the character it had when realized by its controlled foreign corporations for purposes of determining whether the domestic corporation is a personal holding company under section 542. See Rev. Rul. 76-403, page 229.

Section 959. — Exclusion from Gross Income of Previously Taxed Earnings and Profits

26 CFR 1.959-1: Exclusion from gross income of United States persons of previously taxed earnings and profits.

Whether, if an amount taxed to a shareholder of a controlled foreign corporation as subpart F income under section 951(a)(1)(A)(i) of the Code, and invested in U.S. property represents an increase in earnings invested in U.S. property for purposes of section 951(a)(1)(B), such increase is taxable to the controlled foreign corporation's U.S. shareholder. See Rev. Rul. 76-538, page 230.

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26 CFR 1.959-1: Exclusion from gross income of United States persons of previously taxed earnings and profits.

Whether the basis of a U.S. shareholder's stock in its wholly owned controlled foreign corporation is reduced under section 961 of the Code by the amount of the controlled foreign corporation's increase in earnings invested in U.S. property excluded from the shareholder's gross income with respect to the controlled foreign corporation pursuant to section 959(a)(2). See Rev. Rul. 76-538, page 230.

Section 961.—Adjustments To Basis of Stock in Controlled Foreign Corporations and of Other Property

26 CFR 1.961-1: Increase in basis of stock in controlled foreign corporations and of other property.

Whether the basis of a U.S. shareholder's stock in its wholly owned controlled foreign corporation is reduced under section 961 of the Code by the amount of the controlled foreign corporation's increase in earnings invested in U.S. property excluded from the shareholder's gross income with respect to the controlled foreign corporation pursuant to section 959(a)(2). See Rev. Rul. 76-539, page 232.

26 CFR 1.961-2: Reduction in basis of stock in foreign corporations and of other property.
(Also Section 951, 959, 1248; 1.951-1, 1.959-1, 1.1248-2, 1.1248-3.)

Controlled foreign corporation; basis of stock; earnings and profits. The basis of the stock of a controlled foreign corporation in the hands of its domestic parent is not reduced by amounts excluded from the parent's gross income under section 959(a)(2) of the Code and such amounts do not increase the controlled foreign corporation's earnings and profits for purposes of section 1248.

Rev. Rul. 76-539

Advice has been requested regarding the computation of the basis of the stock of a controlled foreign corporation in the hands of its domestic parent and the computation of the controlled foreign corporation's earnings and profits under the circumstances described below.

P is a domestic corporation engaged in a trade or business and *S* is a wholly owned controlled foreign corporation of *P* organized in country *M*.

In April 1974, *S* loaned 10,000*x* dollars to *P* in exchange for *P*'s debt obligation, which qualifies as an obligation of a United States person under section 956(b)(1)(C) of the Internal Revenue Code of 1954, which is generally the type of investment in United States property that would be includible in *P*'s gross income as an increase in earnings invested in United States property for such year under section 951(a)(1)(B). In May 1975, *P* repaid the loan with interest to *S*. In June 1975, *P* realized a gain on the sale of its *S* stock to an unrelated third party.

All of *S*'s income for its taxable years 1974 and 1975 was subpart F income included in *P*'s gross income pursuant to section 951(a)(1)(A)(i) of the Code. The 10,000*x* dollar loan to *P* was an investment in United States property within the meaning of section 956(b), but was excluded from *P*'s gross income pursuant to section 959(a)(2) because all of *S*'s earnings for taxable year 1974 had already been included in *P*'s gross income as subpart F income under section 951(a)(1)(A)(i). *See* Rev. Rul. 76-538, page 230, this Bulletin.

The specific issues presented are the following:

(1) Whether the basis of *P*'s stock in *S* is reduced under section 961(b) of the Code by any amount excluded from *P*'s gross income with respect to *S* pursuant to section 959(a)(2); and

(2) Whether, under section 1248, *S*'s earnings and profits, with respect to *P*, include the amount of such earnings and profits excluded from *P*'s gross income pursuant to section 959(a)(2).

Section 957(a) of the Code provides, in part, that the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by United States shareholders on any day during the taxable year of such foreign corporation.

Section 951(a)(1) of the Code, effective for taxable years beginning before December 31, 1975, provides, in part, that if a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year beginning after December 31, 1962, every person who is a United States shareholder of such corporation and who owns stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in gross income, for such person's taxable year in which or with which such taxable year of the corporaiton ends—

(A) the sum of—
(i) such person's pro rata share of the corporation's subpart F income for such year and
(ii) * * *; and
(B) such person's pro rata share of the corporation's increase in earnings invested in United States property for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

Section 956(b)(1)(C) of the Code provides that an obligation of a United States person is United States property.

Section 959(a) of the Code provides, in part, that the earnings and profits for a taxable year of a foreign corporation attributable to amounts that are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when—

(1) such amounts are distributed to, or

(2) such amounts would, but for section 959(a), be included under section 951(a)(1)(B) in the gross income of,

such shareholder directly, or indirectly, be again included in the gross income of such United States shareholder.

Section 961(a) of the Code provides, in part, that the basis of a United States shareholder's stock in a controlled foreign corporation shall be increased by the amount required to be included in such shareholder's gross income under section 951(a) with respect to such stock, but only to the extent to which such amount was included in such shareholder's gross income.

Section 961(b)(1) of the Code provides, in part, that the adjusted basis of stock with respect to which a United States shareholder receives an amount that is excluded from gross income under section 959(a) shall be reduced by the amount so excluded.

S. Rep. No. 1881, 87th Cong., 2d Sess. 94 (1962), 1962-3 C.B. 707, 800, in discussing section 961 of the Code, provides in part:

> It is necessary where amounts not actually distributed to the taxpayer are nevertheless taxed to him, to increase his basis for the stock in the controlled corporation by the amount so taxed to him. However, if subsequently actual distributions are made which do not result in any tax to the shareholder because of the prior tax pay-

ment by him, then the basis of the stock needs to again be reduced.

S. Rep. No. 1881 indicates that Congress intended to require a reduction in basis under section 961(b)(1) of the Code only when amounts excluded from gross income under section 959(a) are actually distributed to the United States shareholder. Therefore, section 961(b)(1) applies to amounts excluded from gross income under section 959(a)(1) (actual distributions) and not to amounts excluded from gross income under section 959(a)(2) (constructive distributions attributable to increases in earnings invested in United States property). Such a result is logical since under section 961(a) there is an increase in the basis of a shareholder's stock in a controlled foreign corporation in the amount included in the shareholder's gross income under section 951(a) but not distributed to the shareholder. Upon distribution of such amount, section 961(b) provides for a corresponding reduction in basis. In the instant case, however, there is no distribution, but rather a subsequent investment in United States property of previously taxed subpart F income. To reduce the shareholder's basis in such a situation would result in the shareholder's not only having been previously taxed on its subpart F income under section 951 but also being placed in the same position with respect to basis as a shareholder who has actually received the amount included in income under section 951.

Accordingly, with respect to issue (1), pursuant to section 961(a) of the Code, the basis of *P*'s stock in *S* shall include all amounts required to be included in *P*'s gross income under section 951(a) with respect to such stock, to the extent such amounts were included in *P*'s gross income, without reduction under section 961(b) for any amount excluded from *P*'s gross income with respect to *S* pursuant to section 959(a)(2).

Section 1248(a) of the Code provides, in part, that if a United States person sells or exchanges stock in a foreign corporation and such person owns, within the meaning of section 958(a), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of the sale when such foreign corporation was a controlled foreign corporation, then the gain recognized on the sale of such stock shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation attributable to such stock that were accumulated in the period specified therein.

Section 1248(d)(1) of the Code provides, in part, that there shall be excluded, with respect to any United States person, from the earnings and profits of a foreign corporation, earnings and profits attributable to any amount previously included in the gross income of such person under section 951, with respect to the stock sold or exchanged, but only to the extent the inclusion of such amount did not result in an exclusion of an amount from gross income under section 959.

Sections 1.1248-2(e)(3)(ii) and 1.1248-3(e)(2)(i) of the Income Tax Regulations provide that such exclusion from earnings and profits of the foreign corporation is applicable to the extent amounts previously included in the gross income of United States shareholders under section 951 of the Code exceed amounts excluded from such income under section 959(a)(1). That is, the earnings and profits of the foreign corporation are reduced by the amounts previously included in the United States shareholder's gross income under section 951 and then increased to the extent that any portion of that income is excluded from such shareholder's gross income under section 959(a)(1) by way of an actual distribution.

In limiting the increase in earnings and profits to actual distribution situations under section 959(a)(1) of the Code, the regulations under section 1248 necessarily imply that the section 1248(d)(1) exclusion from earnings and profits is not reduced by amounts excluded from the United States shareholder's gross income under section 959(a)(2).

Accordingly, with respect to issue (2), because there was no actual distribution to which section 959(a)(1) of the Code applies but rather an increase in investment in United States property to which section 959(a)(2) applies, the amount of *S*'s earnings and profits does not include the amount of such earnings and profits excluded from *P*'s gross income pursuant to section 959(a)(2).

Section 964.—Miscellaneous Provisions

26 CFR 1.964-1: Determination of the earnings and profits of a foreign corporation.

Whether the amount includible in the gross income of a domestic corporation under section 951(a)(1)(B) of the Code retains the character it had when realized by its controlled foreign corporations for purposes of determining whether the domestic corporation is a personal holding company under section 542. See Rev. Rul. 76-403, page 229.

Part IV.—Domestic International Sales Corporations
Subpart A.—Treatment of Qualifying Corporations

Section 992.—Requirements of a Domestic International Sales Corporation

26 CFR 1.992-1: Requirements of a DISC. (Also Section 993.)

DISC export receipts; purchases for related foreign corporation. For purposes of determining if the "95 percent gross receipts test" of section 992(a)(1)(A) of the Code is satisfied, a DISC that, in addition to income from export sales of its domestic parent's products, also

receives commissions from the parent's foreign subsidiary for making purchases of U.S. manufactured components for the subsidiary's manufacturing operations, will include in its gross receipts as defined in section 993(f) the commissions from the foreign subsidiary but not the total amount of purchases made for it, and such commissions are not "qualified export receipts" under section 993 (a)(1).

Rev. Rul. 76-338

Advice has been requested whether, under the circumstances described below, a Domestic International Sales Corporation (DISC) satisfies the "95 percent gross receipts" test of section 992(a)(1)(A) of the Internal Revenue Code of 1954.

P, a domestic corporation, is engaged in the business of manufacturing electronic products within the United States, which it sells both within and without the United States. *S*, a corporation organized under the laws of country *M*, is a wholly owned subsidiary of *P* and is engaged in the manufacture of electronic products within country *M*.

Y, a wholly owned domestic subsidiary of *P*, has elected to be treated as a DISC. *Y* entered into separate written commission agreements with *P* and *S*. The agreement with *P* grants *Y* a sales franchise with respect to export sales by *P* of electronic products that qualify as export property under section 993(c)(1) of the Code and provides that *Y* will receive commissions with respect to such sales equal to the maximum amount permitted under section 994.

The agreement with *S* designates *Y* as the purchasing agent of *S* for the purchase of United States manufactured components that are used by *S* in the manufacture of its products from unrelated third parties within the United States.

In 1975, *P* received gross receipts in the amount of 4,000*x* dollars from the sale of its products that qualified as export property. Pursuant to the agreement with *P*, *Y* received a commission of 750*x* dollars from such sales. The commission was computed under the "50-50" combined taxable income method described in section 994(a)(2) of the Code. In addition, pursuant to the agreement with *S*, *Y* received a commission of 200*x* dollars for purchases of components arranged by *Y*. The total amount of such purchases was 2,000*x* dollars. *Y* had no other gross receipts in 1975.

The specific questions presented are: (1) whether gross receipts as defined in section 993(f) of the Code include the total amount of the purchases made by *Y* on *S*'s behalf pursuant to their agreement or only the actual commissions received by *Y* from *S*; and (2) whether such gross receipts are qualified export receipts under section 993(a)(1) of the Code.

Section 992(a)(1)(A) of the Code provides, in effect, that in order for a corporation to qualify as a DISC, 95 percent or more of its gross receipts (as defined in section 993(f)) must consist of qualified export receipts.

Section 993(a)(1) of the Code lists the eight types of transactions that result in qualified export receipts. Section 993(a)(1)(A) provides, in part, that qualified export receipts of a corporation include gross receipts from the sale, exchange, or other disposition of export property.

Section 993(f) of the Code provides, in part, that, the term "gross receipts" means the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of trade or business, and gross income from all other sources. In the case of commissions on the sale, lease, or rental of property, the amount taken into account as gross receipts shall be the gross receipts on the sale, lease, or rental of the property on which such commissions arose.

In Rev. Rul. 73-228, 1973-1 C.B. 362, a wholly owned domestic subsidiary of a foreign corporation engaged in the production of paper goods proposed to form a DISC for the purpose of acquiring raw materials produced in the United States for use by the foreign corporation in the production of paper goods. The foreign corporation would purchase the raw materials directly from the United States producers and would pay the DISC a commission on the purchase price on each purchase arranged by the DISC. That Revenue Ruling, emphasizing the distinction between purchases and sales, holds that the commissions to be paid to the proposed DISC in connection with the *purchase* of raw materials would not constitute qualified export receipts under section 993(a) of the Code because such receipts would not be attributable to a *sale* of export property.

In the instant case, the commission received by *Y* pursuant to the agreement with *P* arose from sales by *P* of property held for sale in the ordinary course of *P*'s trade or business. Therefore, pursuant to section 993(f) of the Code, the amount taken into account as gross receipts of *Y* is the gross receipts (4,000*x* dollars) realized by *P* on the sales of electronic products on which *Y*'s commission arose. In addition, since the 4,000*x* dollars arose from export sales of *P* of property that qualified as export property under section 993(c)(1), the 4,000*x* dollars are qualified export receipts of *Y* under section 993(a)(1)(A).

The commission received by *Y* pursuant to the agreement with *S* arose from the purchase of property by *S* from unrelated third parties rather than from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of a trade or business. Therefore, pursuant to section 993(f) of the Code, the amount taken into account as gross receipts by *Y* does not include the total amount of the purchases (2,000*x* dollars) arranged by *Y* on *S*'s behalf, but includes only the gross income of *Y*

from such transactions. The gross income of *Y* for acting as the purchasing agent of *S* under the above agreement is the amount of the commission (200*x* dollars) actually paid to it by *S*. In addition, consistent with the holding in Rev. Rul. 73-228 that commissions paid to a DISC in connection with the purchase of raw materials are not qualified export receipts under section 993(a)(1), the commissions earned by *Y* under its agreement with *S* are not qualified export receipts.

Accordingly, for 1975, *Y* had gross receipts of 4,200*x* dollars, which included 4,000*x* dollars that were qualified export receipts and 200*x* dollars that were not qualified export receipts. Since *Y*'s qualified export receipts (4,000*x* dollars), are greater than 95 percent of *Y*'s total receipts (4,200*x* dollars), *Y* satisfies the "95 percent gross receipts" test of section 992(a)(1)(A) of the Code for 1975.

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26 CFR 1.992-1: Requirements of a DISC. (Also Section 301; 1.301-1.)

DISC deficiency distribution; when taxable. A deficiency distribution made by a DISC for the purpose of qualifying as a DISC for a previous taxable year is includible in the gross income of the DISC's shareholder in the year actually received.

Rev. Rul. 76-499

Advice has been requested concerning the year of inclusion in the income of a Domestic International Sales Corporation's (DISC) shareholder, of a distribution made by the DISC for the purpose of qualifying as a DISC for a previous taxable year.

During an examination by the Internal Revenue Service in 1976, the examining agent properly found that 20 percent of a DISC's receipts in 1974 were not qualified export receipts. As a result of the examination, the DISC made a deficiency distribution pursuant to section 1.992-3 of the Income Tax Regulations for the purpose of qualifying as a DISC for 1974.

The question is whether the shareholder should include the distribution in income in 1974 or 1976.

Section 301(a) of the Internal Revenue Code of 1954, provides, in part, that a distribution of property made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in section 301(c). Section 301(c) provides that the portion of the distribution that is a dividend shall be included in gross income.

Section 992(c) of the Code provides, in part, that a corporation that for a taxable year does not satisfy certain conditions relating to gross receipts or assets, shall nevertheless be deemed to satisfy such conditions for such year if it makes a deficiency distribution after the close of the taxable year to its shareholders with respect to their stock.

Section 1.301-1(b) of the regulations provides, in part, that a distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

The purpose of a deficiency distribution is to cure a nonqualifying DISC, provided all the prerequisites for initial qualifications are met. Actual distributions of a DISC are taken into account by the shareholders in the year of receipt and any deficiency distribution is deemed to have occurred prior to other actual distributions during the taxable year.

A shareholder of a DISC has no more rights to, or interest in, a deficiency distribution prior to receipt than it would prior to the payment of any other distribution. The DISC is in possession and control of such assets until their distribution.

Accordingly, a deficiency distribution is included in the income of a DISC's shareholder in the year received notwithstanding that the purpose for such distribution was to qualify the corporation as a DISC for a previous taxable year.

Section 993.—Definitions

DISC export property; restoration of machine components. The domestic restoration of previously manufactured machine components, acquired from foreign businesses for less than 10 percent of their restored fair market value, by a U.S. corporation for sale through its wholly owned DISC to foreign customers for direct use outside the U.S. is manufacturing within the meaning of section 993(c)(1)(A) of the Code and the components qualify as export property for DISC purposes.

Rev. Rul. 76-272

Advice has been requested whether the restoration of previously manufactured machine components, under the circumstances decribed below, is manufacturing within the meaning of section 993(c)(1)(A) of the Internal Revenue Code of 1954.

S, a Domestic International Sales Corporation (DISC), acts as a commission agent for its parent, *P* corporation, in *P*'s export sales of certain restored machine components.

P acquires previously manufactured machine components from foreign businesses at a nominal price at a time when such components are no longer functional and would normally be scrapped. At its factory in the United States, *P* then completely reconditions such components, restoring them to their original working order, and sells them to its foreign customers. The cost of such restoration accounts for 95 percent of the cost of goods sold of each component. Consequently, less than 10 percent of the fair market value of such component is attributable to the fair market value of articles that are imported into the United States.

Section 991 of the Code provides

that, for purposes of the Federal income tax, a DISC shall not be subject to Federal income taxes except those imposed by chapter 5, subtitle A of the Code.

Section 992(a) of the Code provides, in part, that 95 percent or more of the gross receipts of a DISC must consist of "qualified export receipts."

Section 993(a)(1)(A) of the Code provides, in part, that qualified export receipts include gross receipts from the sale, exchange, or other disposition of "export property."

Section 993(c)(1) of the Code provides, in part, that export property must be property, (A) that is manufactured, produced, grown, or extracted in the United States by a person other than a DISC, (B) held primarily for sale in the ordinary course of business by or to a DISC for direct use, consumption, or disposition outside the United States and (C) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

Property that is sold is considered to be manufactured by a person for purposes of section 993(c) of the Code if with respect to such property conversion costs (direct labor and factory burden including packaging or assembly) of such person account for 20 percent or more of the cost of goods sold or inventory amount of such person for such property if such property is sold or held for sale.

The restoration process involved in the instant case meets the requirement for manufacturing under section 993(c)(1)(A) of the Code because the property conversion costs account for more than 20 percent of the cost of goods sold.

The fact that the components have been previously manufactured does not prevent their restoration from being considered manufacturing within the meaning of section 993(c)(1)(A) of the Code.

Thus, the extensive restoration performed by P that transforms scrap into functional components is manufacturing within the meaning of section 993(c)(1)(A) of the Code. *P* also holds such restored components primarily for sale in the ordinary course of a trade or business for direct use outside the United States within the meaning of section 993(c)(1)(B). Finally, not more than 50 percent of the value of the restored components is attributable to articles imported into the United States within the meaning of section 993(c)(1)(C). Accordingly, the restored components qualify as export property under section 993(c).

DISC; retainages recorded in accounts receivable purchased. Retainages recorded in accounts receivable, purchased by a DISC from its parent, that arose from the parent's sales of qualified export property under contracts providing for a retainage of 10 percent of the contract price by the buyer until the equipment met certain guaranteed performance levels are accounts receivable and qualified export assets under section 993(b)(3) of the Code.

Rev. Rul. 76-284

Advice has been requested whether, under the circumstances described below, the retainages recorded in the accounts receivable purchased by a Domestic International Sales Corporation (DISC) are accounts receivable and thus qualified export assets within the meaning of section 993(b)(3) of the Internal Revenue Code of 1954.

In 1974 *P*, a domestic corporation, organized *S*, a corporation that qualified as a DISC. *P* and *S* entered into a written agreement under which *S* acts as a commission agent for *P*'s export business that consists of selling equipment that *P* manufactures. During 1974 *S* purchased trade accounts receivable from *P* with the commissions it earned from *P*. Both *P* and *S* reported their income for Federal income tax purposes under an accrual method of accounting.

The trade accounts receivable purchased by *S* from *P* arose from contracts for sales of equipment. The equipment qualified as export property under section 993(c) of the Code.

The sales contracts underlying the trade accounts receivable purchased by *S* from *P* provided for a retainage of 10 percent of the contract price by the buyer of the equipment until such time as the equipment meets certain guaranteed performance levels as specified in the contract. Consistent with the sales contracts, *P* does not bill the buyers for the retainages (10 percent) until the guaranteed performance levels are achieved. However, *P* includes the amount of the retainages in its income when it sells the trade accounts receivable to *S* for the full amount of the sales contract (including retainages), or when the equipment meets the guaranteed performance levels, whichever is earlier. *See* Rev. Rul. 69-314, 1969-1 C.B. 139. Thus, when *P* sells the accounts receivable to *S*, *P* has realized all the income to be realized with respect to the receivable.

Section 993(b)(3) and section 993(a)(1)(A) of the Code, when read together, provide that qualified export assets of a corporation include accounts receivable and evidences of indebtedness that arise by reason of the sale of export property. A DISC may acquire such receivables directly as the result of sales of qualified export property, and, if the DISC acts as a commission agent for a principal in any such transaction, it may acquire the receivables arising from the sale. *See* Rev. Rul. 75-430, 1975-2 C.B. 313.

Section 9-106 of the Uniform Commercial Code (1972 version), provides as follows:

> "Account" means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance.

The official comments to the Uniform Commercial Code state that an "account" is defined as the "ordinary commercial account receivable," and it has been held that the terms account and accounts receivable may be used interchangeably. *See In re Varney Wood Products, Inc.*, 458 F.2d 435 (4th Cir. 1972).

In the instant case, the rights acquired by *S* with respect to the retainages are accounts receivable for purposes of the Uniform Commercial Code. In addition, notwithstanding that such rights will not be earned until the specified performance levels are achieved, *P* has realized all the income to be realized with respect to the retainages. Finally, these retainages arise in connection with the sale of export property.

Accordingly, the retainages recorded in the accounts receivable purchased by *S* are accounts receivable and thus qualified export assets under section 993(b)(3) of the Code.

DISC export receipts; textbook sales to schools in foreign countries. Receipts from the sale of textbooks produced in the U.S. by a domestic corporation and sold by its wholly owned DISC to private, independent schools located in foreign countries and owned and operated by associations of the U.S. citizen-parents of the children enrolled in the schools are qualified export receipts within the meaning of section 993(a)(1)(A) of the Code.

Rev. Rul. 76-458

Advice has been requested whether, under the circumstances described below, receipts from the sale of textbooks to overseas schools sponsored by citizens of the United States are qualified export receipts within the meaning of section 993(a)(1)(A) of the Internal Revenue Code of 1954.

P, a domestic corporation, is engaged in the business of producing and selling textbooks. In 1975, *P* organized a wholly owned domestic subsidiary, *S*, as a Domestic International Sales Corporation (DISC). *P* entered into a written agreement with *S* whereby *S* was granted a franchise with respect to the export sales of the textbooks produced by *P*. Pursuant to such agreement, *P* sells the textbooks to *S* and *S* resells the textbooks to customers outside the United States.

The textbooks sold by *S* are produced by *P* within the United States and are held primarily for sale by *S* in the ordinary course of its trade or business for direct use, consumption, or disposition outside the United States. Less than 50 percent of the fair market value of the textbooks is attributable to articles imported into the United States.

S sells the textbooks to schools sponsored by citizens of the United States located in foreign countries. These schools are private, independent institutions that are owned and operated by associations of the parents of the children enrolled in the schools, which are not operated by the United States government. The school associations are incorporated under the laws of the foreign countries in which they are operated.

Section 993(a)(1)(A) of the Code provides, in part, that the qualified export receipts of a corporation include gross receipts from the sale, exchange, or other disposition of export property.

Section 993(a)(2)(C) of the Code provides, in part, that the Secretary of the Treasury or the Secretary's delegate may under regulations designate receipts from the sale of export property as not being receipts described in section 993(a)(1) if the Secretary determines that such sale is for use by the United States or any instrumentality thereof where the use of such export property is required by law or regulation.

Section 993(c)(1) of the Code defines export property to mean property—

(A) manufactured, produced, grown, or extracted in the United States by a person other than a DISC,

(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a DISC, for direct use, consumption, or disposition outside the United States, and

(C) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

Rev. Rul. 55-384, 1955-1 C.B. 94, provides, in part, that kindergarten and nursery schools organized and operated on United States bases or installations located in foreign countries or possessions of the United States are not agencies or instrumentalities of the United Sttaes within the meaning of sections 911(a) or 931(i) of the Code, when operated on a permissive basis rather than under official instructions or regulations, and when the support of which is furnished by the parents of the pupils.

Thus, the schools involved herein are private, independent institutions owned and operated by the parents of the students and are not instrumentalities of the United States. Since the textbooks sold by *S* are produced by *P* within the United States and are held by *S* primarily for sale in the ordinary course of its trade or business for direct use, consumption, or disposition outside the United States, and since less than 50 percent of the fair market value of the textbooks is attributable to articles imported into the United States, the textbooks are export property within the meaning of section 993(c) of the Code.

Accordingly, the receipts from the sale of the textbooks by *S* to schools located outside the United States and sponsored by United States citizens are qualified export receipts within the meaning of section 993(a)(1)(A) of the Code.

Whether the gross receipts, as defined in section 993(f) of the Code, of a DISC received pursuant to an agreement that designates the DISC as a purchasing agent include the total amount of the purchase made by a DISC pursuant to such agreement or only the actual commissions received. See Rev. Rul. 76-338, page 233.

Section 994.—Intercompany Pricing Rules

26 CFR 1.994-1: Intercompany pricing rules for DISC's.

T.D. 7435

TITLE 26—INTERNAL REVENUE CHAPTER 1, SUBCHAPTER A, PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Certain intercompany pricing rules for DISC's

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C., 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

By a notice of proposed rule making appearing in the Federal Register for Wednesday, July 16, 1975 (40 FR 29871), amendments to the Income Tax Regulations (26 CFR Part 1) under certain provisions of sections 993 and 994 of the Internal Revenue Code of 1954 were proposed in order to provide certain intercompany pricing rules for DISC's. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, certain changes were made and the proposed amendments of the regulations under section 994, subject to such changes, are adopted by this document. Such changes made by this document may be summarized as follows:

1. The rule proposed in § 1.994-1(c)(6)(v) with respect to determination of combined taxable income has been slightly modified to avoid any inference that the transfer at a discount of an account receivable can result in a deductible loss. If a related supplier transfers an account receivable to its DISC at a discount, the amount of such discount will, in effect, be excluded from combined taxable income. It is understood that the discounts described in such provision which arise on the transfer of accounts receivable by a related supplier to a DISC may be grouped in the same manner that the transactions to which such accounts receivable relate are grouped by the taxpayer pursuant to § 1.994-1(c)(7).

2. Section 1.994-1(e)(3)(i) has been modified in order to make clear that it is a reasonable estimate, of the transfer price or sales commission actually charged, which must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

3. Section 1.994-1(e)(3)(ii) has been expanded in order to make obvious the relationship between the form of a commission payment to a DISC and the 95 percent qualified export assets test. A commission payment to a DISC need not take the form of a qualified export asset. However, the 95 percent test of section 992(a)(1)(B) (relating to qualified export assets) will apply to the DISC as of the close of its taxable year.

4. Section 1.994-1(e)(3)(iii) in the notice provided that an account receivable arising upon the failure to pay, or the payment of an unreasonably small estimate of, a transfer price or commission will be deemed to arise as of the date the transaction occurred which gave rise to the account receivable. In response to public comment this document also provides that, if the transaction occurred in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the receivable will be deemed to arise as of the date by which payment was required. A similar change was made in § 1.994-1(e)(5)(iii) and the examples in § 1.994-1(e)(6) were conformed to such change.

5. Section 1.994-1(e)(3)(iv) has been expanded by the addition of a rule providing, in the case of incomplete transactions which were initiated during a taxable year ending after August 15, 1975, when an amount paid by a DISC to a related supplier in respect of property transferred to a DISC shall be deemed to be a reasonable estimate of the transfer price for such property. If any one of the three tests set forth is satisfied, the amount actually paid shall be deemed to meet the requirements of § 1.994-1(e)(3) with respect to the incomplete transaction.

6. Section 1.994-1(e)(5)(i) has been modified to make clear that an account receivable (not described in § 1.994-1(e)(5)(iii)) representing the difference in amount between the transfer price (or commission) determined and the sum previously paid and received shall be treated as an asset as of the end of the taxable year of the DISC in which the transaction occurred which gave rise to the indebtedness. Such account receivable will be treated as a trade receivable (and, therefore, as a qualified export asset) only if it is paid within 90 days after the date it is established.

7. Section 1.994-1(e)(5)(v) has been added to make clear the nature of the adjustment procedures (provided by paragraph (e)(5)) with respect to incomplete transactions.

The amendments to the regulations under § 1.993-2(d)(2) and (3) proposed in paragraph 1 of the appendix to the notice of proposed rule making are not adopted by this document but do remain outstanding. It is anticipated that such amendments will be adopted at the time a Treasury decision providing the regulations under section 993 generally is published.

Adoption of amendments to the regulations

On Wednesday, July 16, 1975, a notice of proposed rule making was published in the Federal Register (40 FR 29871) in order to conform the Income Tax Regulations (26 CFR Part 1) to certain provisions of sections 993 and 994 of the Internal

Revenue Code of 1954. After consideration of all such relevant matters as were presented by interested persons regarding the rules proposed, the amendments of the regulations under section 994 as proposed in paragraph 2 of the appendix to such notice are hereby adopted, subject to the changes set forth below:

The amendments to § 1.994-1, as set forth in paragraph 2 of the notice of proposed rule making, are revised by amending paragraph (c)(6)(v), by amending subdivisions (i), (ii), (iii), and (iv) of paragraph (e)(3), by amending subdivisions (i) and (iii) of paragraph (e)(5), by adding a new subdivision (v) to paragraph (e)(5), and by amending paragraph (e)(6). The amended and added provisions read as follows:

§ 1.994-1 Intercompany pricing rules for DISC's.

* * * * *

(c) *Transfer price for sales of export property.* * * *

(6) *Combined taxable income.* * * *

(v) If an account receivable arising with respect to a sale of export property is transferred by the related supplier to a DISC which is a member of the same controlled group within the meaning of § 1.993-1(k) for an amount reflecting a discount from the selling price taken into account in computing (without regard to this subdivision) combined taxable income of the DISC and its related supplier, then the combined taxable income from such sale shall be reduced by the amount of the discount.

* * * * *

(e) *Methods of applying paragraphs (c) and (d) of this section.* * * *

(3) *Initial payment of transfer price or commission.* (i) The amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

(ii) Payment must be in the form of money, property (including accounts receivable from sales by or through the DISC), a written obligation which qualifies as debt under the safe harbor rule of § 1.992-1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction. The form of the payment to a DISC need not be a qualified export asset under § 1.993-2. However, for the requirement that the adjusted basis of the qualified export assets of the DISC at the close of its taxable year must equal or exceed 95 percent of the sum of the adjusted bases of all assets of the DISC at the close of its taxable year, see section 992(a)(1)(B).

(iii) If the district director can demonstrate, based upon the data available as of the 60th day after the close of such taxable year, that the amount actually paid did not represent a reasonable estimate of the transfer price or commission (as the case may be) to be determined under section 994 and this section, an indebtedness will be deemed to arise, from the person required to make the payment in favor of the person to whom the payment is required to be made, in an amount equal to the difference between the amount of the transfer price or commission determined under section 994 and this section and the amount (if any) actually paid and received. Such indebtedness will be deemed to arise as of the date the transaction occurred which gave rise to the indebtedness, except that, if such transaction occurred in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the indebtedness will be deemed to arise as of the date by which payment was required under subdivision (i) of this paragraph (e)(3). Such indebtedness owed to a DISC shall be treated as an asset but shall not be treated as a trade receivable or other qualified export asset (see § 1.993-2(d)(3)) as of the end of the taxable year of the DISC in which the indebtedness is deemed to arise.

(iv) (*a*) Except with respect to incomplete transactions to which paragraph (c)(5)(i)(*b*) of this section applies, if the amount actually paid results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction as reported in its tax return for the taxable year the transaction is completed, then the amount actually paid shall be deemed to be a reasonable estimate of such transfer price or commission.

(*b*) With respect to incomplete transactions to which paragraph (c)(5)(i)(*b*) of this section applies and which were initiated during a taxable year ending after August 15, 1975, the amount actually paid shall be deemed to be a reasonable estimate of such transfer price if any one of the following three tests is met:

(*1*) The amount actually paid by the DISC to the related supplier in respect of the property does not exceed the related supplier's cost of goods sold (see paragraph (c)(6)(ii) of this section) with respect to the property.

(*2*) If the transaction is completed by the date on which the DISC's return is required to be filed for the year in which the transaction was initiated, the amount actually paid by the DISC to the related supplier in respect of the property results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction when completed.

(*3*) The percentage that (*i*) an

amount equal to (*a*) the amount actually paid by the DISC to the related supplier in respect of the property minus (*b*) the related supplier's cost of goods sold with respect to the property, bears to (*ii*) the related supplier's cost of goods sold in respect of the property, is not greater than 50 percent of the percentage that (*iii*) the combined taxable income for completed transactions of the same group as the property during the DISC's taxable year in which the incomplete transaction was initiated, bears to (*iv*) the cost of goods sold of the related supplier and DISC with respect to such transactions.

(*c*) For purposes of this subdivision (iv), whether the transfer price or commission actually paid is deemed a reasonable estimate may be determined on the basis for grouping transactions chosen by the taxpayer under paragraph (c)(5) and (7) of this section.

* * * * *

(5) *Procedure for adjustments to transfer price or commission.* (i)(*a*) If the transfer price (or commission) for a transaction determined under section 994 is different from the price (or commission) actually charged, the person who received too small a transfer price (or commission) or paid too large a transfer price (or commission) shall establish (or be deemed to have established), at the date of the determination or redetermination under subparagraph (4) of this paragraph of the transfer price (or commission) under section 994, an account receivable from the person with whom it engaged in the transaction equal to the difference in amount between the transfer price (or commission) so determined and the transfer price (or commission) previously paid and received. If, the account receivable is paid within 90 days after the date it is established (or deemed established), then as of the end of the taxable year of the DISC in which the transaction occurred which gave rise to the indebtedness, the account receivable shall be treated as an asset and, under § 1.993-2(d)(3) as a trade receivable, and thus as a qualified export asset.

(*b*) If, for example, during 1972, a DISC which uses the calendar year as its taxable year sold a product which it purchased that year from its related supplier and paid a price of $10,000 which price is a reasonable estimate under subparagraph (3)(iii) of this paragraph but is later determined under section 994 to be $8,000 immediately before the DISC filed its return for 1972, the DISC must be paid $2,000 (*i.e.*, $10,000—$8,000) by its related supplier or establish an account receivable from its related supplier of $2,000. The account receivable may be paid without tax consequences, provided that such account receivable is paid within 90 days after the date it is established (or deemed established). Such account receivable paid within such 90 days will be considered to relate to the taxable year in which the transaction occurred which gave rise thereto rather than the taxable year during which it is established or paid.

(ii) Payment must be in a form specified in subparagraph (3) of this paragraph.

(iii) If an account receivable of a DISC described in subdivision (i) of this paragraph (e)(5) is not paid within 90 days of the date it is established (or deemed established), then, as of the end of the taxable year of the DISC in which the transaction occurred which gives rise to the indebtedness, the account receivable shall be treated as an asset except that, if the account receivable is established (or deemed established) in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the account receivable shall be treated as an asset as of the end of such taxable year. However, under § 1.993-2(d)(3), an account receivable referred to in the preceding sentence shall not be treated as a trade receivable or other qualified export asset.

(iv) An account receivable established in accordance with subdivision (i) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482-2(a)(2) from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxpayer's taxable income for each taxable year during which the account receivable is oustanding.

(v) The procedure for adjustments to transfer price provided by this subparagraph does not apply to incomplete transactions described in paragraph (c)(5)(i)(*b*) of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

(6) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) During 1975, a DISC which uses the calendar year as its taxable year purchased a product from its related supplier and made an initial payment of $8,500. If $8,500 were determined to be the transfer price under section 994, the DISC's taxable income from the transaction would be $1,000. Immediately before the DISC filed its return for 1975, under section 994 it is determined that the transfer price is $8,000 and the DISC's taxable income is $1,500. Thus, the requirement of a reasonable estimate under subparagraph (3) of this paragraph was met because the amount ($8,500) actually paid resulted in the DISC realizing taxable income of $1,000 which is not less than 50 percent of the DISC's taxable income ($1,500) from the transaction as determined under section 994.

(ii) Pursuant to subparagraph (5) of this paragraph, an account receivable due the DISC for $500, *i.e.*, $8,500—$8,000, is established on September 15, 1976, the DISC files its return for 1975, and is paid on December 1, 1976. The account receivable for $500 will be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto and will be a qualified export asset under §1.993-2(d)(3) for the last day of such year.

Example (2). Assume the same facts as in example (1) except that the account re-

ceivable for $500 is paid on January 1, 1977. The account receivable for $500 will still be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto. However, such account receivable will be treated as an asset which is not a qualified export asset under §1.993-2(d)(3) for the last day of such year.

* * * * *

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved September 20, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 29, 1976; 8:45 a.m., published in the issue of the Federal Register for September 30, 1976, 41 F.R. 43141)

Subchapter O.—Gain or Loss on Disposition of Property
Part I.—Determination of Amount of and Recognition of Gain or Loss

Section 1001.—Determination of Amount of and Recognition of Gain or Loss

26 CFR 1.1001-1: Computation of gain or loss.

Whether the face value or the fair market value of the silver content of United States silver coins is used to determine the amount received in the sale or exchange of property. See Rev. Rul. 76-249, page 21.

Part III.—Common Nontaxable Exchanges

Section 1031.—Exchange of Property Held For Productive Use or Investment

26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment.

Leasehold sale and leaseback of portion used income of two businesses. The assignment of a corporation's long-term leasehold interest in a building, in part used for its retail operations and the remainder subleased as office space, in return for an identical leasehold in the retail portion of the building, qualifies as an exchange of property for like kind property and money and, although the transaction resulted in a disposition of property used in one of the corporation's businesses, a loss realized in the exchange will not be recognized.

Rev. Rul. 76-301

Advice has been requested concerning the treatment for Federal income tax purposes of the transfer of a lease and leasehold improvements in a building in return for the leaseback of a portion of the building and money under the circumstances described below.

X corporation is engaged in the retail clothing business. Its main store is located in the first five stories and basement of a 20-story building. The entire building was leased by *X* in 1940 under a lease agreement that ends on June 30, 2000.

At all times since 1940 *X* has used the first five floors and basement for its retail operations. The balance of the building (15 floors) was made into office space and sublet to others. Prior to January 2, 1973, *X* made various leasehold improvements most of which benefited the entire building (elevators, air conditioning, boilers, and similar improvements).

On January 2, 1973, *X* consummated a transaction with *Z*, an unrelated corporation, whereby *Z* acquired *X*'s entire leasehold interest including all of *X*'s leasehold improvements, except those that only benefited the retail store. The agreement between *X* and *Z* called for a sublease to *X* for the full term of the underlying lease with respect to the first five floors and basement of the building. The agreement also provided for a payment of 1,000*x* dollars purchase price by *Z* determined by the value of the leasehold interest and improvements of floors 6 through 20 of the building. *X*'s adjusted basis of the nonretail store leasehold interest and improvements (except those improvements attributable to the retail store) was 1,200*x* dollars.

The specific question in the instant case is whether an exception to the application of section 1031(a) and (c) of the Internal Revenue Code of 1954, which precludes recognition of loss may be justified because the transaction results in the disposition of the portion of the property used in connection with one of *X*'s two businesses. If an exception is applicable, *X* will recognize a 200*x* dollar loss.

Section 1031(a) of the Code provides, in part, that no gain or loss shall be recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.

An exchange is considered to occur for the purposes of section 1031 of the Code if the transfers of the like kind property are reciprocal. Rev. Rul. 61-119, 1961-1 C.B. 395. Moreover, the reciprocal transfer of interests in like kind property is an exchange for the purposes of section 1031 even though the interests are in the same property. *See Century Electric Co. v. Commissioner,* 192 F.2d 155 (8th Cir. 1951), *cert. denied,* 342 U.S. 954 (1952), where a loss sustained on the sale of business property by a taxpayer was disallowed where it immediately leased back the same property under a long-term lease.

Section 1.1031(a)-1(a) of the Income Tax Regulations provides that property held for productive use in trade or business may be exchanged for property held for investment. Similarly, property held for investment may be exchanged for property held for productive use in a trade or business.

Section 1.1031(a)-1(b) of the reg-

ulations provides that the words "like kind" in section 1031 of the Code have reference to the nature and character of the property and not its grade or quality. Furthermore, no gain or loss is recognized as a result of the exchange by a taxpayer, who is not a dealer in real estate, of city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate. Section 1.1031(a)-1(c) of the regulations. Thus, the exchange of a long term leasehold interest in a building in return for an identical leasehold interest in another building or a portion of a building would qualify as a like kind exchange subject to section 1031.

Section 1031(c) of the Code provides, in part, that if an exchange would be within the provisions of section 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

Consequently, the assignment of the leasehold interest in the building in the instant case in return for an identical leasehold interest in a portion of the building qualifies as an exchange of property for like kind property and money subject to section 1031(c) of the Code.

The fact that the transaction results in the disposition of the portion of the property used in one of the taxpayer's two businesses is not significant for the purposes of section 1031 of the Code. Section 1.1031(a)-1(a) of the regulations. Rather, the significant factor for the purposes of section 1031 is that the taxpayer's investment is still tied up in the same kind of property. *See H. R. Rep. No. 704,* 73d Cong., 2d Sess. 13 (1934), 1939-1 (Part 2) C.B. 554, 564.

Accordingly, the loss of 200*x* dollars realized by *X* in the exchange of *X*'s leasehold interest and improvements in the building in return for an identical leasehold interest in a portion of the building and money may not be recognized under the provisions of section 1031(a) and (c) of the Code.

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26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment.

Whether gain or loss is recognized on an exchange of property where the exchange did not qualify as a contribution of the taxpayer's undivided interest in the property within the meaning of section 170 of the Code. See Rev. Rul. 76-253, page 51.

Section 1033.—Involuntary Conversions

26 CFR 1.1033(a)-2: Involuntary conversion where disposition of the converted property occurred after December 31, 1950.

Involuntary conversion; billiard center as replacement property for bowling center. A billiard center in which the taxpayer invested the insurance proceeds from a bowling center which was destroyed by fire is not similar or related in service or use to the converted property and does not qualify as replacement property under section 1033 of the Code.

Rev. Rul. 76-319

Advice has been requested whether, under the circumstances described below, property qualifies as replacement property for purposes of section 1033 of the Internal Revenue Code of 1954.

The taxpayer, a domestic corporation, was engaged in the operation of a recreational bowling center prior to the center's complete destruction by fire on June 30, 1974. The bowling center had consisted of bowling alleys, together with a lounge area and a bar. The center was fully insured against loss by fire. As a result of such insurance coverage the taxpayer received insurance proceeds in compensation for the destruction of the bowling center in an amount that exceeded the taxpayer's basis in the property. On its Federal income tax return for 1974, the taxpayer elected to defer recognition of the gain under the provisions of section 1033 of the Code.

Within the period specified in section 1033(a)(3)(B) of the Code, the taxpayer invested the insurance proceeds in a new recreational billiard center. In addition to billiard tables, this center includes a lounge area, and a bar.

Section 1033(a) of the Code provides, in part, that if property (as a result of its destruction in whole or in part) is involuntarily converted into money, the gain shall be recognized except as provided in section 1033(a)(3)(A). Section 1033(a)(3)(A) provides, in part, that if the taxpayer during the period specified purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized on the conversion exceeds the cost of such other property.

The specific question is whether the recreational billiard center (replacement property) is "similar or related in service or use" to the recreational bowling center (involuntarily converted property) within the meaning of section 1033(a) of the Code.

Rev. Rul. 64-237, 1964-2 C.B. 319, states that, with respect to an owner-user, property is not considered similar or related in service or use to the converted property unless the physical characteristics and end uses of the converted and replacement properties are closely similar.

In the instant case, the involuntarily converted property was a bowling center that consisted of bowling alleys together with a lounge area and a bar. The replacement property consists of a billiards center that included billiard tables, a lounge area, and a bar. The physical characteristics of the

replacement property are not closely similar to those of the converted property since bowling alleys and bowling equipment are not closely similar to billiard tables and billiard equipment.

Accordingly, in the instant case, the billiard center is not similar or related in service or use to the bowling center within the meaning of section 1033(a)(3)(A) of the Code. Therefore the billiard center does not qualify as replacement property for purposes of section 1033.

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26 CFR 1.1033(a)-2: Involuntary conversion where disposition of the converted property occurred after December 31, 1950.

Involuntary conversions; replacement by owner-operator; motel for mobile home park. The investment of proceeds from the condemnation of a portion of the taxpayer's owned and operated mobile home park in a motel to be built and operated by the taxpayer on the remaining portion will not qualify as the purchase of property similar or related in service or use or as like kind property under the nonrecognition-of-gain provisions of section 1033 of the Code.

Rev. Rul. 76-390

Advice has been requested whether the investment of condemnation proceeds, under the circumstances described below, will qualify as a replacement of property similar or related in service or use to the property involuntarily converted, under section 1033 of the Internal Revenue Code of 1954.

The taxpayer owned and operated a 15-acre mobile home park in state *M*. The operation consisted of renting space to accommodate mobile home trailers. In 1975 state *M* filed an action to condemn 10 of the 15 acres for a highway. The judgment in condemnation was an award in the amount of 50,000*x* dollars for the land. At the time of condemnation the taxpayer had a basis in the condemned land of 10,000*x* dollars. After the condemnation action, a portion of the mobile home park consisting of 5 acres remained. The taxpayer proposes to use the condemnation proceeds in the construction of a motel on the remaining 5 acres with the intent to operate the motel.

Section 1033(a)(3)(A) of the Code provides, in part, that if property is compulsorily or involuntarily converted into money and the taxpayer, during the period specified, purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other property.

Rev. Rul. 64-237, 1964-2 C.B. 319, states that with respect to owner-users of property, property is not considered similar or related in service or use to the converted property unless the physical characteristics and end uses of the converted and replacement properties are closely similar.

Section 1033(g) of the Code provides, in part, that if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted after December 31, 1957, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Rev. Rul. 67-255, 1967-2 C.B. 270, states that the effect of section 1033(g) of the Code is to extend the nonrecognition-of-gains benefits of section 1033(a) to a taxpayer who acquires property of a like kind to real property converted, but not necessarily similar or related in service or use to the converted property. Rev. Rul. 67-255 holds that an office building, to be held for investment purposes, that was constructed upon land already owned by the taxpayer, does not qualify as being of a like kind to the land that was involuntarily converted. Although the term "real estate" is often used to embrace land and improvements thereon, land and improvements are by nature not alike merely because one term is used to describe both. Land is not of the same nature or character as a building.

Applying the above reasoning to the facts in the instant case, the motel to be constructed on land already owned will not qualify under section 1033(a) of the Code as being similar or related in service or use to the condemned mobile home park because (1) the physical characteristics and end uses of a motel are not closely similar to those of a mobile home park and (2) the motel and the land that it will replace are not "like kind" property under section 1033(g).

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26 CFR 1.1033(a)-2: Involuntary conversion where disposition of the converted property occurred after December 31, 1950. (Also Section 1.1033(g)-1.)

Involuntary conversion; replacement by lessor; commercial building for farmland. A commercial building, to be held for rental on a net-lease basis, built on land owned by the taxpayer with the proceeds from the involuntary conversion of unimproved farmland leased for many years to tenant farmers will not qualify as property similar or related in service or use or as like kind property under the nonrecognition-of-gain provisions of section 1033 of the Code.

Rev. Rul. 76-391

Advice has been requested whether the nonrecognition-of-gain provisions of section 1033 of the Internal Revenue Code of 1954 are applicable under the circumstances described below.

Under a threat of condemnation, the taxpayer sold 50*x* acres of its farmland to a municipality. The farmland, which was not improved with build-

ings such as a farm house or a barn, had been leased by the taxpayer to tenant farmers continuously since 1950. The sale constituted an involuntary conversion of real property held for productive use in a trade or business or for investment within the meaning of section 1033 of the Code. The proceeds from the sale were used to construct a commercial building on other land already owned by the taxpayer.

The building is suitable for leasing as five separate units, the interior of which are not finished. Parking facilities surrounding the building have been provided. It is anticipated that the taxpayer will perform no interior or exterior maintenance on the building structure because the building will be leased on a net-lease basis. However, the taxpayer will be responsible for the parking lot and will have to make physical changes to the building to accommodate new tenants. The taxpayer will also be responsible for maintenance when vacancies occur. Electricity, telephone service, and water will be provided to the building and individually charged to the tenants by the utility companies involved. The real property taxes upon the subject property will be paid by the taxpayer and reimbursed by the tenants on a pro rata basis. All taxes or personal property of the tenants will be paid by the tenants. The insurance coverage will be added to the taxpayer's existing insurance policy coverage and the cost thereof reimbursed by the tenants on a pro rata basis.

Specifically, the question presented is whether a commercial building, to be held for rental, that was constructed upon property owned by the taxpayer is "property similar or related in service or use" to the converted farmland, within the meaning of section 1033(a) of the Code.

Section 1033(a)(3)(A) of the Code provides, in part, that if property is compulsorily or involuntarily converted into money and the taxpayer, during the period specified, purchases other property similar or related in service or use to the property so converted, then at the election of the taxpayer, gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other property.

Rev. Rul. 64-237, 1964-2 C.B. 319, states that in considering whether replacement property acquired by an investor is similar in service or use to the converted property, attention will be directed primarily to the similarity in the relationship of the services or uses that the original and replacement properties have to the taxpayer-owner. In applying this test, a determination will be made as to whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with the properties, and what the properties demand of the taxpayer in the way of management, services, and relations to its tenants. See also *Liant Record, Inc. v. Commissioner,* 303 F.2d 326 (2d Cir. 1962).

In the instant case, the taxpayer constructed a commercial building dependent upon the needs of prospective tenants. Although the taxpayer intends to lease the building on a net-lease basis, it will be responsible for its maintenance when vacancies occur. In addition, the taxpayer will be responsible for the maintenance of a parking lot and will be required to make physical changes in the building to accommodate new tenants. On the other hand, the farmland that had been leased by the taxpayer to the tenant farmers required no maintenance.

Accordingly, under the test enunciated in Rev. Rul. 64-237, a commercial or industrial building to be held for lease does not qualify as property similar or related in service or use to leased farmland within the meaning of section 1033(a) of the Code.

Section 1033(g) of the Code provides, in part, that if real property held for productive use in trade or business or for investment is, as the result of its sale under threat of condemnation, compulsorily or involuntarily converted, then property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted for purposes of section 1033(a).

Rev. Rul. 67-255, 1967-2 C.B. 270, states that the effect of section 1033(g) of the Code is to extend the nonrecognition-of-gains benefits of section 1033(a) to a taxpayer who acquires property of a like kind to real property converted, but not necessarily similar or related in service or use to the converted property. Rev. Rul. 67-255 holds that an office building, to be held for investment purposes, that was constructed upon land already owned by the taxpayer does not qualify as being of a like kind to the land that was involuntarily converted. Although the term "real estate" is often used to describe both land and improvements on the land, land and improvements are by nature not alike merely because one term is used to describe both. Land is not of the same nature or character as a building.

In accordance with Rev. Rul. 67-255, the commercial building, to be held for lease, that was constructed upon land owned by the taxpayer does not qualify as a like-kind replacement of its leased farmland within the meaning of section 1033(g) of the Code.

Therefore, the nonrecognition-of-gain provisions of section 1033 of the Code are not applicable in the instant case because neither the test enunciated in Rev. Rul. 64-237 nor the "like kind" test of section 1033(g) have been satisfied.

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26 CFR 1.1033(a)-2: Involuntary conversion where disposition of the converted property occurred after December 31, 1950.

Replacement of involuntarily converted property; sewer morato-

rium prohibiting construction. A sewer moratorium, the duration of which cannot be ascertained, prohibiting new construction in the immediate area of condemned investment property is not reasonable cause for the granting of an extension of time to replace the involuntarily converted property.

Rev. Rul. 76-488

Advice has been requested whether, under the circumstances described below, an extension of time to replace involuntarily converted property under section 1.1033(a)-2(c)(3) of the Income Tax Regulations will be granted.

X, a domestic corporation, received 150*x* dollars in 1974 as a result of the condemnation of its real property held for investment purposes, which resulted in a gain to *X*.

Following the involuntary conversion, *X* attempted to reinvest the proceeds from the condemnation award. However, because of a sewer moratorium prohibiting new construction, *X* was unable to locate suitable replacement property in the immediate area of the condemned property. In addition, *X* was unable to ascertain when the sewer moratorium would be lifted. Consequently, *X* was not able to replace the converted property within the period specified in section 1033(a)(3)(B)(i) of the Internal Revenue Code of 1954 (2 years after the close of the first taxable year (1974) in which any part of the gain from the involuntary conversion was realized by *X*).

X requested from the District Director of Internal Revenue an extension of time to replace the involuntarily converted property. *X* made the request pursuant to section 1.1033(a)-2(c)(3) of the regulations and prior to the termination of the period specified in section 1033(a)(3)(B)(i) of the Code.

Section 1.1033(a)-2(c)(3) of the regulations provides, in part, that no extension of time shall be granted unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

Rev. Rul. 60-69, 1960-1 C.B. 294, states that the granting of such extensions depends on the facts and circumstances in each particular case and indicates that neither the high market value nor the scarcity of replacement property is a sufficient ground for granting an extension.

Accordingly, *X* will not be granted an extension of time under the provisions of section 1.1033(a)-2(c)(3) of the regulations to replace the converted property because the fact that suitable replacement property was not available in the immediate area of the condemned property is not reasonable cause for granting an extension.

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26 CFR 1.1033(a)-2: Involuntary conversion where disposition of the converted property occurred after December 31, 1950.

Replacement of involuntarily converted property; sewer moratorium; expected limited duration. A sewer moratorium that county officials expect to be lifted before the expiration of the requested extension is reasonable cause for the granting of an extension of time to replace involuntarily converted property with qualified property upon which the taxpayer has acquired an option; Rev. Rul. 76-488 distinguished.

Rev. Rul. 76-540

Advice has been requested whether, under the circumstances described below, an extension of time to replace involuntarily converted property under section 1.1033(a)-2(c)(3) of the Income Tax Regulations will be granted.

X, a domestic corporation that uses a calendar year for Federal income tax purposes, is engaged in the development and sale of real property. In 1973 *X* received 150*x* dollars as a result of the condemnation of a portion of its real property. The taxpayer realized a gain on the condemnation and, under the provisions of section 1033 of the Internal Revenue Code of 1954, elected to defer the recognition of the gain on its 1973 Federal income tax return.

Following the involuntary conversion, *X* attempted to reinvest the proceeds from the condemnation award. Because of a sewer moratorium in the immediate area of the converted property, *X* was not able to replace the converted property within the period specified in section 1033(a)(3)(B)(i) of the Code (2 years after the close of the first taxable year (1973) in which any part of the gain from the involuntary conversion was realized by *X*).

On December 15, 1975, *X* entered into an arm's length option agreement with *Y*, an unrelated domestic corporation. Pursuant to the agreement, *X* obtained for 10*x* dollars an option to purchase two plots of land in the same area as the converted property by November 30, 1976, that would qualify as replacement property under section 1033 of the Code. In addition, *X* has been informed by reliable officials of the county government in which the two plots are located that the sewer moratorium will be lifted by the fall of 1976.

Pursuant to section 1.1033(a)-2(c)(3) of the regulations, *X* applied to the appropriate district director of the Internal Revenue Service for an extension of time to November 30, 1976, to replace the converted property.

Section 1.1033(a)-2(c)(3) of the regulations provides, in part, that no extension of time shall be granted unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

Rev. Rul. 76-488, page 244, this Bulletin, holds that existence of a sewer moratorium in the immediate area is not a reasonable cause for the granting of an extension of time under the

provisions of section 1.1033(a)-2(c)(3) of the regulations to replace the converted property.

Rev. Rul. 60-69, 1960-1 C.B. 294, states that the granting of such extensions depends on the facts and circumstances in each particular case and states that neither high market value nor the scarcity of replacement property is a sufficient ground for granting an extension. However, that Revenue Ruling further indicates that when the taxpayer is attempting to secure specific replacement property but such replacement cannot be completed within the statutory period, a request for a reasonable extension of such period will be granted.

Rev. Rul. 70-502, 1970-2 C.B. 166, provides, in part, that when a taxpayer did not have enough cash to purchase replacement property within the statutory period and had neither identified specific replacement property nor adopted a definite schedule to secure the funds necessary to purchase replacement property, no extension of time would be granted.

In the instant case, *X* was not able to purchase suitable replacement property within the period specified by section 1033(a)(3)(B)(i) of the Code because of the existence of a sewer moratorium in the immediate area of the converted property. Pursuant to Rev. Rul. 76-488 the existence of the sewer moratorium is not in itself a sufficient ground for granting an extension.

However, although the existence of obstacles to replacement (such as a sewer moratorium) is not in itself a sufficient ground for the granting of an extension, a taxpayer can show reasonable cause for the granting of an extension if the taxpayer is attempting to acquire specific replacement property and needs more time to complete the acquisition and if the taxpayer has obtained adequate information that the obstacles to such acquisition will be removed during a reasonable extension period.

In the instant case, *X* has entered into an arm's length option agreement to purchase specific replacement property by November 30, 1976, and has obtained adequate information that indicates that the sewer moratorium will be lifted by the fall of 1976.

Accordingly, *X* will be granted an extension of time until November 30, 1976, under the provisions of section 1.1033(a)-2(c)(3) of the regulations to replace the involuntarily converted property.

Rev. Rul. 76-488 is distinguished.

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26 CFR 1.1033(g)-1: Condemnation of real property held for productive use in trade or business or for investment.

Whether a commercial building, to be held at lease, that was constructed upon property already owned by the taxpayer with proceeds received by it from the involuntary conversion of its leased unimproved farmland qualifies as a like-kind replacement of property within the meaning of section 1033(g) of the Code. See Rev. Rul. 76-391, page 243.

Section 1034.—Sale or Exchange of Residence

26 CFR 1.1034-1: Sale or exchange of residence.

Residence and contiguous land sold separately; nonrecognition of gain. The nonrecognition of gain provisions of section 1034 of the Code will apply to gains realized by a taxpayer on the separate sale of a house situated on a parcel of land and the sale of a contiguous parcel later in the same year, both parcels of land having been used as the taxpayer's principal residence, and the construction in the same year of a new principal residence whose cost exceeded the total adjusted sales price of the combined properties; Rev. Rul. 56-420 distinguished.

Rev. Rul. 76-541

Advice has been requested whether, under the circumstances described below, the nonrecognition provisions of section 1034 of the Internal Revenue Code of 1954 apply to the gain realized from the separate sale of land included in a parcel contiguous to a principal residence sold by an individual taxpayer.

The taxpayer owned and resided in a house situated on an undivided parcel of land containing 10 acres. The entire 10-acre parcel was used as a part of the taxpayer's principal residence. In early 1975, the taxpayer sold the house and three acres of land immediately surrounding the house. The boundaries of the three acres were established by survey, but the 7-acre portion of the original parcel was not divided. The taxpayer also attempted to sell a part of the 7-acre portion along with the three acres, but such attempt was unsuccessful.

A few weeks after the sale, the taxpayer began construction of a house on the remaining 7-acre portion to be used as a new principal residence. The house was completed and occupied by the taxpayer in late 1976.

Prior to the end of 1975, the taxpayer sold two acres of the 7-acre parcel to another purchaser. At no time was any portion of the ten acres held by the taxpayer for investment or for use in a trade or business.

The taxpayer realized a gain from each of the sales transactions. The taxpayer combined the gain from the sale of the old residence and three acres of land with the gain from the sale of the two-acre parcel and treated all such gain as gain from the sale of the old residence. The cost of constructing the new residence exceeded the total adjusted sales price of the combined properties and the taxpayer applied the nonrecognition provisions of section 1034 of the Code to all gain realized from the sales.

Section 1034(a) of the Code provides, in part, that if property used by the taxpayer as a principal residence is sold by the taxpayer, and within a period beginning 18 months

before the date of such sale and ending 18 months after such date, property is purchased and used by the taxpayer as a principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence.

Section 1034(c)(2) of the Code provides, in part, that a residence any part of which was constructed or reconstructed by the taxpayer shall be treated as purchased by the taxpayer.

Section 1034(c)(5) of the Code provides, in part, that in the case of a new residence the construction of which was commenced by the taxpayer before the expiration of 18 months after the date of the sale of the old residence, the period specified in section 1034(a) shall be treated as including a period of two years beginning with the date of the sale of the old residence.

In *Bogley v. Commissioner*, 263 F.2d 746 (4th Cir. 1959), *reversing* 30 T.C. 452 (1958), individual taxpayers acquired thirteen acres of land in 1939 and constructed a residence in which they lived until December 1, 1950, when they moved into a new residence located several miles from the old residence. Prior to December 31, 1950, the taxpayers sold the old residence and three acres of land. The remaining ten acres were sold in 5-acre parcels in June and August of 1951. The United States Court of Appeals reasoned that the thirteen acres intact were part of the taxpayers' old residence and that the character of the remaining ten acres did not change. Thus, the Court held that the gain realized from the sale of the ten acres in June and August of 1951 was entitled to the benefit of the nonrecognition provisions of section 112(n)(1) of the Internal Revenue Code of 1939 as added by section 318(a) of the Revenue Act of 1951. However, since section 112(n)(1) (the predecessor of section 1034 of the 1954 Code) applied only with respect to residences sold after December 31, 1950, the taxpayers were required to report gain and pay capital gain tax attributable to the sale of the house and three acres.

In the instant case, before the sale of the 3-acre portion, the original parcel of 10 acres was the taxpayer's "old principal residence." As in *Bogley*, the fact that the taxpayer sold the 3-acre portion of the property on which the house was located prior to selling the two acres of the remaining seven acres of land does not alter the character of the two acres. The 2-acre portion remains part of the taxpayer's "old principal residence" for the length of the replacement period, despite the fact that the taxpayer constructed and occupied a "new principal residence" on the adjacent five acres.

Since the new principal residence was constructed rather than purchased, under section 1034(c)(5) of the Code the taxpayer's replacement period is two years beginning with the date of the sale of the 3-acre parcel of land containing the taxpayer's old principal residence. The subsequent separate sale of the 2-acre parcel of land does not cause a new replacement period to begin.

Accordingly, the nonrecognition provisions of section 1034 of the Code apply to the gain realized from the sale of the 3-acre parcel of land containing the taxpayer's house, and also to the gain realized from the separate sale of the 2-acre parcel of land.

Rev. Rul. 56-420, 1956-2 C.B. 519, is distinguishable. That Revenue Ruling holds, in part, that the benefits of section 1034(a) of the Code are inapplicable to the sale of a portion of a city lot on which a taxpayer's house was located since the property sold did not include the taxpayer's dwelling. The taxpayer did not purchase a new house but rather continued to reside in the old house.

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26 CFR 1.1034-1: Sale or exchange of residence.

Whether reimbursement for loss sustained from the sale of a personal residence is part of the amount realized from such sale. See Rev. Rul. 76-342, page 22.

Part VII.—Wash Sales of Stock or Securities

Section 1091.—Loss from Wash Sales of Stock or Securities

26 CFR 1.1091-1: Losses from wash sales of stock or securities.

Wash sales; substantially identical securities. U.S. Treasury 6⅜ percent bonds maturing in 1982 and not redeemable at par with accrued interest for payment of estate taxes and U.S. Treasury 4¼ percent bonds maturing in 1992 and redeemable at par with accrued interest for payment of estate taxes are not "substantially identical" securities within the meaning of the wash sales provisions.

Rev. Rul. 76-346

Advice has been requested whether United States Treasury 6⅜ percent bonds and the United States Treasury 4¼ percent bonds are "substantially identical" securities within the meaning of section 1091 of the Internal Revenue Code of 1954, relating to losses from wash sales of securities.

The taxpayer sold United States Treasury 6⅜ percent bonds at a loss and purchased, within 30 days, United States Treasury 4¼ percent bonds. The United States Treasury 6⅜ percent bonds are dated February 15, 1972, and mature February 15, 1982. These bonds are not redeemable at par with accrued interest for application in payment of Federal estate taxes. The United States Treasury 4¼ percent bonds are dated August 15, 1962, and mature August 15, 1992. The 4¼ percent bonds are redeemable at par with accrued interest for application in payment of Federal estate taxes.

Section 1091(a) of the Code provides, in part, that in the case of any loss claimed to have been sustained from any sale of stock or securities

where it appears that, within a period beginning 30 days before the date of such sale and ending 30 days after such date, the taxpayer has acquired or has entered into a contract or option to acquire, substantially identical stock or securities, no deduction for the loss shall be allowed under section 165 (c)(2).

Generally, bonds are not "substantially identical" if they are substantially different in any material feature, or because of differences in several material features considered together. Rev. Rul. 58-210, 1958-1 C.B. 523, and Rev. Rul. 58-211, 1958-1 C.B. 529, 530. *See also Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939).

In this case, there is a substantial difference between the two bonds in the annual interest rates, maturity dates, and their use in payment of Federal estate taxes. All these factors are material and considered together render the respective bonds substantially different.

Accordingly, in the instant case, the United States Treasury 6⅜ percent bonds and the United States Treasury 4¼ percent bonds are not "substantially identical" securities within the meaning of section 1091 of the Code.

Subchapter P.—Capital Gains and Losses
Part I.—Treatment of Capital Gains

Section 1201.—Alternative Tax

26 CFR 1.1201-1: Alternative tax. (Also Section 1235; 1.1235-1.)

Capital gains; alternative tax; sale of patent by corporate taxpayer. A domestic manufacturing corporation's gain from the sale of a patent under a binding contract, entered into before October 9, 1969 with all amounts received before 1975, is not a gain from a transaction described in section 1235 of the Code and qualifies for the alternative tax under section 1201 as a subsection (d) gain.

Rev. Rul. 76-414

Advice has been requested whether, under the circumstances described below, the gain from the sale of a patent is "subsection (d) gain" as defined in section 1201(d)(1) of the Internal Revenue Code of 1954.

Prior to October 9, 1969, the taxpayer, a domestic corporation engaged in the manufacturing business, entered into a binding contract for the sale of a patent. The contract required payments to be made to the taxpayer over a number of years all prior to 1975. The sale resulted in a long-term capital gain for the taxpayer.

Section 1201(d)(1) of the Code states, in part, that for purposes of that section, the term subsection (d) gain means the sum of the long-term capital gains for the taxable year arising in the case of amounts received before January 1, 1975, from sales or other dispositions pursuant to binding contracts (other than any gain from a transaction described in sections 631 or 1235) entered into on or before October 9, 1969.

Section 1235(a) of the Code and section 1.1235-1(a) of the Income Tax Regulations state, in part, that a transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein that includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months.

Section 1235(b) of the Code defines the term "holder" as being:

(1) any individual whose efforts created such property, or,

(2) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(A) the employer of such creator, nor

(B) related to such creator (within the meaning of subsection (d)).

Section 1.1235-1(b) of the regulations describes the scope of section 1235 of the Code and states that if a transfer is not one described in section 1.1235-1(a), section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by section 1235. The tax consequences of such transfer shall be determined under other provisions of the internal revenue laws.

Section 1201(d)(1) of the Code excludes from the definition of subsection (d) gains, gains from transactions described in section 1235. A transfer of a patent by a corporation is not a transaction described in section 1235, however, because a corporation cannot be a holder of a patent as defined in section 1235(b).

Accordingly, in the instant case, because the taxpayer's gain is not derived from a transaction described in section 1235 of the Code, and because the requirements of section 1201(d) are otherwise satisfied, that gain is subsection (d) gain within the meaning of section 1201(d).

Part IV.—Special Rules for Determining Capital Gains and Losses

Section 1232.—Bonds and Other Evidences of Indebtedness

26 CFR 1.1232-1: Bonds and other evidences of indebtedness; scope of section.

Whether interest earned on a time savings certificate is to be reported as original issue discount on Form 1099-OID. See Rev. Rul. 76-449, page 393.

Section 1235.—Sale or Exchange of Patents

26 CFR 1.1235-1: Sale or exchange of patents.

Whether the gain from the sale of a patent is "subsection (d) gain" as defined in section 1201(d)(1) of the Code. See Rev. Rul. 76-414, this page.

Section 1236.—Dealers in Securities

26 CFR 1.1236-1: Dealers in securities.

Dealers in securities; stock acquired in reorganization. Stock acquired by a dealer in securities in a transaction qualifying as a reorganization under section 368(a)(1)(A) of the Code, in exchange for stock held as an inventory item, may be designated as securities held for investment under section 1236.

Rev. Rul. 76-392

Advice has been requested whether, under the circumstances described below, certain securities may be designated as securities held for investment under section 1236 of the Internal Revenue Code of 1954.

X corporation, a dealer in securities, has for many years engaged in the purchase and sale of *Y* corporation stock. On July 31, 1973, in a transaction qualifying as a reorganization within the meaning of section 368(a)(1)(A) of the Code, *Y* was merged into *Z* corporation. In exchange for each share of *Y* stock held, *X* received 1.1 shares of *Z* stock. At all times prior to the merger, *X* held the shares of *Y* as an inventory item. Two days after receipt of the *Z* shares in exchange for the *Y* shares pursuant to the reorganization, *X* designated in its records the *Z* shares as being held for investment.

Section 1236(a)(1) of the Code allows a dealer in securities 30 days from the date of acquisition of a security to designate such security as held for investment. A security under section 1236 includes shares of stock in any corporation.

The question presented is whether the *Z* stock received by *X* corporation as a result of the merger was an "acquisition" within the meaning of section 1236 of the Code.

The term "acquisition" is not defined in section 1236 of the Code, the income tax regulations thereunder, or the relevant Congressional committee reports. Under these circumstances the meaning of the term "acquisition" is to be determined in light of the purpose for which section 1236 was enacted.

Section 1236 of the Code was enacted to forestall the practice of securities dealers manipulating their inventory and investment accounts to obtain capital gains treatment on securities sold at a gain and ordinary loss treatment on those securities sold at a loss. *H.R. Rep. No. 586,* 82nd Cong., 1st Sess. (1951), 1951-2 C.B. 357, 376; *S. Rep. No. 781,* 82nd Cong., 1st Sess. (1951), 1951-2 C.B. 458, 482.

In deciding what the term "acquisition" means for purposes of section 1236(a)(1) of the Code, it is helpful to examine several revenue rulings that have defined "acquisition" under other Code sections. Rev. Rul. 63-170, 1963-2 C.B. 286, provides, in part, that the term "acquisition", as used in section 851(d), includes the receipt of securities as a result of either a reorganization described in section 368(a)(1)(C) or an antitrust order.

Rev. Rul. 74-133, 1974-1 C.B. 165, provides that a mere change in the number of shares representing an original investment in a corporation does not constitute an acquisition for purposes of section 851(d) of the Code. Rev. Rul. 74-133 distinguished Rev. Rul. 63-170 on the ground that the stock received in that case was obtained in exchange for stock of another corporation in an acquisitive reorganization described in section 368(a)(1)(C).

Under these Revenue Rulings, the determination whether there has been an acquisition for purposes of section 851(d) of the Code depends on whether there has been a mere change in the number of shares representing the original investment in a corporation as opposed to a change in the nature or extent of such investment.

However, Rev. Rul. 56-171, 1956-1 C.B. 179, holds that for purposes of section 333(f) of the Code the controlling "acquisition" date of securities received in a statutory merger is the original date of acquisition of the stock surrendered in the exchange. The date of acquisition limitation of section 333(f)(1) is designed to prevent liquidating corporations from converting cash into securities in an attempt to postpone recognition of gain to the extent of cash that would otherwise be distributed in the liquidation.

The difference in result reached in Rev. Rul. 56-171 and Rev. Rul. 63-170 can be explained by examining the underlying purposes of the Code sections involved in these Revenue Rulings. With respect to Rev. Rul. 56-171 involving section 333 of the Code, that section provides limited nonrecognition of gain to qualified electing shareholders in certain complete liquidations. Gain is recognized to the extent of the greater of (1) the shareholder's ratable share of earnings and profits accumulated after February 28, 1913, or (2) the sum of money and stock or securities acquired by the liquidating corporation after December 31, 1953. This "after acquired" stock is treated the same as cash to prevent the liquidating corporation from converting cash into stock or securities in an attempt to defer recognition of gain at the shareholder level.

In contrast, with respect to Rev. Rul. 63-170, dealing with section 851(d) of the Code, the possibility of converting cash into stock or securities is not relevant to the underlying purposes of section 851(d).

To qualify as a "regulated investment company" under the statutory definition, a domestic corporation must satisfy the diversification of investment requirements set forth in section 851(b)(4) and (c) of the Code. This section requires that certain prescribed percentages of the company's total assets must be represented by cash and securities with the amount of investment in a particular company not exceeding a designated percentage. The diversification requirements of section 851 are designed to prevent regulated investment companies from concentrating their investment assets

in a small number of companies or in certain forms of assets. Relief from a strict mechanical application of the percentage limitations is provided in section 851(d), however, which distinguishes between cases where the failure to comply with the percentage limitations results from a fluctuation in the market value of the investment assets held and not from an "acquisition" of a new or additional investment. Section 851(d) permits the corporation 30 days after the quarter in which the acquisition occurred to correct any violations of the investment requirements. Within these two broad areas of classification it was reasonable to give the term "acquisition" an expansive interpretation to further the legislative objective of prohibiting concentration of investment assets. One of the relevant questions under section 851(d) is whether or not there has been any change in the form or nature of the investment itself as opposed to a mere fluctuation in the value of the original investment.

By comparing the respective legislative objectives underlying the statutes, the interpretation of "acquisition" applicable for purposes of section 851 (d) of the Code should be deemed controlling for purposes of section 1236(a)(1). The securities dealers' identification requirements are designed to compel dealers to affirmatively designate the classification of each security held to bar the tax-motivated shifting of securities from inventory to investment accounts. When there is a change in the security held, the dealer should be entitled to reconsider the investment potential of the security and where appropriate make a new election with regard to the tax status to be afforded the security.

Thus, as in the case of section 851 (d) of the Code, one of the relevant considerations for purposes of section 1236(a)(1) is whether there has been a significant change in the nature of the investment itself. There has been such a change in the instant case.

Accordingly, the *Z* stock received by *X* pursuant to the merger may be designated as securities held for investment under section 1236(a)(1) of the Code.

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26 CFR 1.1236-1: Dealers in securities.

Dealers in securities; identification of securities held for investmet. The provisions of Rev. Rul. 64-160, relating to the identification of securities held by dealers for investment, are modified to include any security as defined in section 1236(c) of the Code and to provide that the nominee in whose name the securities are held may be the nominee of either the clearing company or the participating securities dealer.

Rev. Rul. 76-489

The purpose of this Revenue Ruling is to modify certain provisions of Rev. Rul. 64-160, 1964-1 (Part 1) C.B. 306, dealing with the stock identification requirements of section 1.1236-1(d)(1)(ii) of the Income Tax Regulations.

Rev. Rul. 64-160 sets forth instructions to be followed by security dealers and clearing companies with whom such dealers deposit stocks, in order for the stock to be considered clearly identified as held for investment.

Rev. Rul. 64-160 applies only to stock as defined in instruction number 9 of the Revenue Ruling, which provides that the term "stock" includes only stock listed or traded on a national security exchange registered with the Securities and Exchange Commission and stock rights and warrants so listed and traded thereon.

Until recently a clearing company, as described in Rev. Rul. 64-160, held no securities other than stock listed or traded on a national security exchange registered with the Securities and Exchange Commission and stock rights and warrants so listed and traded thereon. Currently, however, through the development of new systems and techniques, securities held by a clearing company may include a large number of unlisted equity securities and listed and unlisted debt securities such as bonds, notes and other evidences of indebtedness.

Rev. Rul. 64-160 also contains language that may be reasonably construed to provide that the nominee in whose name securities are held must be the nominee of the participating dealers and brokers who deposit securities with the clearing company. At the time of publication of Rev. Rul. 64-160, the securities held by the clearing company in depository accounts were held in the name of the nominee of the participating dealers and brokers. Currently such securities are also held in the name of the nominee of the clearing company.

Section 1236(a) of the Internal Revenue Code of 1954 provides, in part, that gains by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset unless the security was, before the expiration of the 30th day after the day of its acquisition, clearly identified as a security held for investment.

Section 1.1236-1(d)(1) of the regulations provides, in part, that a security is clearly identified in the dealer's records as a security held for investment when there is an accounting separation of the security from other securities, as by making appropriate entries in the dealer's books of account to distinguish the security from inventories and to designate it as an investment, and by (i) indicating with such entries, to the extent feasible, the individual series of or other characteristic symbol imprinted upon, the individual security, or (ii) adopting any other method of identification satisfactory to the Commissioner of Internal Revenue.

Section 1236(c) of the Code provides, in part, that the term "security"

means any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

In the light of current clearing company securities transactions, the identification instructions of Rev. Rul. 64-160 can be utilized with respect to any security as defined in section 1236(c) of the Code in order to allow a clear identification of such security as an investment security. In addition, whether the nominee in whose name investment securities are held is that of the clearing company or the participating dealer is not critical to a clear identification of the securities held for investment.

Accordingly, Rev. Rul. 64-160 is modified to allow its instructions to be applied to any security as defined in section 1236(c) of the Code and to remove the implication in that Revenue Ruling that the nominee in whose name the securities are held must be the nominee of the participating securities dealer. The nominee in whose name securities are held may be the nominee of the clearing company or the nominee of the participating securities dealer.

Rev. Rul. 64-160 is modified.

Section 1245.—Gain from Dispositions of Certain Depreciable Property

26 CFR 1.1245-1: General rule for treatment of gain from dispositions of certain depreciable property.
(Also Sections 167, 882; 1.167(a)-1, 1.882-1.)

Section 1245 property disposition; oil drilling rig removed from U.S. waters. A foreign corporation engaged in oil drilling operations in U.S. territorial waters has not disposed of property for purposes of the recapture provisions of section 1245 of the Code by its permanent removal of a drilling rig from the territorial waters of the U.S. for use in other parts of the world.

Rev. Rul. 76-339

Advice has been requested whether, under the circumstances described below, there has been a "disposition" of an oil drilling rig (rig) for purposes of section 1245 of the Internal Revenue Code of 1954.

The taxpayer, a foreign corporation, purchased a new rig and entered into oil drilling operations in the territorial waters of the United States.

The taxpayer filed its Federal income tax returns reporting its income from the operation of the rig in accordance with section 882 of the Code, which pertains to the tax on income of foreign corporations effectively connected with the conduct of a trade or business within the United States and claimed deductions relating thereto including depreciation on the rig at an accelerated rate under the applicable provisions of section 167. At the end of the third year of operation in the territorial waters of the United States, the taxpayer permanently removed the rig from drilling operations there and used it in other parts of the world, outside of the taxing jurisdiction of the United States. At the time the rig was moved from the territorial waters of the United States, its fair market value exceeded its adjusted basis, as determined under section 1011.

Section 1245(a)(1) of the Code provides that except as otherwise provided therein, if section 1245 property is disposed of during a taxable year beginning after December 31, 1962, the amount by which the lower of (a) the recomputed basis of the property, or (b) in the case of a sale, exchange, or involuntary conversion, the amount realized, or in the case of any other disposition, the fair market value of such property exceeds the adjusted basis of the property shall be treated as gain from the sale or exchange of property that is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provisions of subtitle A of the Code.

Section 1245(a)(3) of the Code provides, in part, that for purposes of section 1245, the term "section 1245 property" means any personal property that is or has been property of a character subject to the allowance for depreciation provided in section 167.

Section 1.1245-1(a)(3) of the Income Tax Regulations provides that for purposes of such section and sections 1.1245-2 through 1.1245-6, the term disposition includes a sale in a sale-and-lease-back transaction and a transfer upon the foreclosure of a security interest, but such term does not include a mere transfer of title to a creditor upon creation of a security interest or to a debtor upon termination of a security interest. Thus, for example, under section 1.1245-1(a)(3) a disposition occurs upon the sale of property pursuant to a conditional sales contract even though the seller retains legal title to the property for purposes of security.

Prior to the enactment of the Revenue Act of 1962, 1962-3 C.B. 111, which added section 1245 to the Code, gain from the disposition of depreciable property was taxed as a capital gain, even though the depreciation deduction had reduced ordinary income. Congress set forth a specific statutory scheme in section 1245 as a means of recapturing excessive depreciation deduction as ordinary income. A necessary event for the application of section 1245 is that section 1245 property be "disposed of" during the taxable year. The House of Representatives Ways and Means Committee Report accompanying the Revenue Act of 1962 states that ". . . The term 'disposed of' includes any transfer or involuntary conversion . . ." *H.R. Rep. No. 87-1447*, 87th Cong., 2nd. Sess. A107 (1962), 1962-3 C.B. 405, 605. The terms "disposed of" or "disposition" as used in section 1245 follow the accepted definition of disposition,

meaning the parting with or the giving up of property—a deed by which a right to property is conveyed. *See Black's Law Dictionary* 558 (Revised 4th ed. 1968).

There has been no disposition of property in the instant case. The removal of the rig from the taxing jurisdiction of the United States is not considered a disposition of property inasmuch as the ownership of such property remains with the taxpayer.

Accordingly, the taxpayer's removal of the drilling rig from United States territorial waters is not a disposition of property for purposes of section 1245 of the Code.

Section 1248.—Gain from Certain Sales or Exchanges of Stock in Certain Foreign Corporations

26 CFR 1.1248-1: Treatment of gain from certain sales or exchanges of stock in certain foreign corporations.

Rev. Proc. 76-4 is modified to provide a new effective date for section 367 rulings issued in conjunction with the closing agreements described therein. See Rev. Proc. 76-44, page 668.

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26 CFR 1.1248-2: Earnings and profits attributable to a block of stock in simple cases.

Whether a controlled foreign corporation's earnings and profits with respect to its shareholders under section 1248 of the Code include the amount of such earnings and profits excluded from the shareholder's gross income pursuant to section 959(a)(2). See Rev. Rul. 76-539, page 232.

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26 CFR 1.1248-3: Earnings and profits attributable to stock in complex cases.

Whether a controlled foreign corporation's earnings and profits with respect to its shareholder under section 1248 of the Code include the amount of such earnings and profits excluded from the shareholder's gross income pursuant to section 959(a)(2). See Rev. Rul. 76-539, page 232.

Subchapter S.—Election of Certain Small Business Corporations as to Taxable Status

Section 1371.—Definitions

26 CFR 1.1371-1: Definition of small business corporation.

Whether a taxpayer whose income is principally derived from dividends of a "small business corporation" has shown a substantial business purpose for the granting of a change of annual accounting period under section 1.442-1(b) of the regulations. See Rev. Rul. 76-407, page 127.

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26 CFR 1.1371-1: Definition of small business corporation.

Small business corporation deriving its primary income for the leasing of automobiles and trucks under leases exceeding one year. See Rev. Rul. 76-469, this page.

Section 1372.—Election by Small Business Corporation

26 CFR 1.1372-1: Election by small business corporation.

Whether a corporation electing to be treated as a small business corporation can secure the benefit of exemption from Federal income taxation if the principal purpose in creating such corporation is to secure such exemption. See Rev. Rul. 76-363, page 90.

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26 CFR 1.1372-1: Election by small business corporation.

Whether an electing small business corporation has shown a substantial business purpose for the granting of a change of its annual accounting period under section 1.442-1(b) of the regulations where it desires to change its annual accounting period from a calendar year to a fiscal year ending March 31 in order to simplify the allocation of its income between selling and purchasing shareholders. See Rev. Rul. 76-497, page 128.

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26 CFR 1.1372-4: Termination of election. (Also Section 1371; 1.1371-1.)

Small business corporation; motor vehicle leasing. Amounts received by an electing small business corporation that, as part of its business of leasing motor vehicles under long-term leases, provides maintenance, repair, and other significant services to the lessee are not rents within the meaning of section 1372(e)(5) of the Code.

Rev. Rul. 76-469

Advice has been requested whether, under the circumstances described below, amounts received by a small business corporation in connection with the long-term leasing of motor vehicles are rents within the meaning of section 1372(e)(5) of the Internal Revenue Code of 1954.

M is a small business corporation as defined in section 1371 of the Code. Its primary source of income is from the leasing of automobiles and trucks for a fixed weekly or monthly rental that is not related to the normal purchase price. The lease period ordinarily exceeds one year but is substantially less than the useful life of the vehicle. The lease does not transfer equitable ownership of the vehicle to the lessee. With respect to such leases, *M* performs services for the convenience of the lessee without additional charge to the lessee. *M* assists the lessee in selecting the proper ve[illegible]le and will install or coordinate th[illegible]n-stallation of any special equipment. *M* will deliver the vehicle to the lessee up to 300 miles from *M*'s home office. Prior to delivery of the vehicle *M* furnishes each lessee a credit card that permits the lessee, during the term of the lease, to purchase tires, batteries, glass, and to obtain maintenance services such as oil and filter changes, lubrications, tune-ups and other vehicle repairs at a discount and to bill *M* for such purchases and services. *M* pays for such purchases and then bills the lessee in the exact amount. If a lessee wishes, *M* will arrange to have repairs performed. In such a case, *M* inspects the vehicle after the repairs have been made and returns the vehicle to the lessee at no extra charge. In many instances during the life of a lease, *M* performs repairs not covered by the manufacturer's warranty in its own shop, or pays to have them done. In such case supplemental transportation is supplied at no charge to the lessee.

Section 1372(e)(5) of the Code provides, in part, that a small business corporation's election not to be subject to the taxes imposed by chapter I of subtitle A of the Code, but to

have all of its income taxed directly to its shareholders, shall be terminated if for any taxable year more than 20 percent of the gross receipts of the corporation is derived from rents and certain other types of income.

In the instant case, the services furnished by *M* as part of its business of leasing motor vehicles under long-term leases are significant services within the meaning of section 1.1372-4(b)(5)(vi) of the regulations.

Accordingly, the amounts received by *M* under the circumstances described above are not "rents" within the meaning of section 1372(e)(5) of the Code.

See Rev. Rul. 65-40, 1965-1 C.B. 429, which holds similarly with respect to amounts received by a corporation in connection with the short-term leasing of motor vehicles.

Section 1373.—Corporation Undistributed Taxable Income Taxed to Shareholders

26 CFR 1.1373-1: Corporation undistributed taxable income taxed to shareholders.

Whether cash equal to a shareholder's net share of previously taxed income is distributable without recognition of gain upon liquidation of an electing small business corporation pursuant to section 333 of the Code. See Rev. Rul. 76-347, below.

Section 1375.—Special Rules Applicable to Distributions of Electing Small Business Corporations

26 CFR 1.1375-4: Distributions of previously taxed income.
(Also Sections 333, 1373; 1.333-4, 1.1373-1.)

Small business corporations; cash distribution to sole shareholder upon liquidation. A cash distribution to the sole shareholder of an electing small business corporation liquidated pursuant to section 333 of the Code is not a distribution of the shareholder's net share of previously taxed income.

Rev. Rul. 76-347

Advice has been requested whether cash equal to a shareholder's net share of previously taxed income is distributable without recognition of gain upon liquidation of an electing small business corporation pursuant to section 333 of the Internal Revenue Code of 1954.

X, an electing small business corporation that files its Federal income tax return on a calendar year basis, has for several years had one shareholder, *A*. As of January 1, 1975, all shares of *X* stock owned by *A* had the same basis, and holding periods in excess of six months. *A*'s basis for all the *X* stock was $30x$ dollars, and *A*'s share of previously taxed income was $12x$ dollars. *X* had accumulated earnings and profits of $5x$ dollars.

On November 3, 1975, a plan of liquidation was adopted and *A* filed a valid election to postpone recognition of gain under section 333 of the Code. On November 5, 1975, pursuant to the plan of liquidation, *X* distributed all its cash, $13x$ dollars, to *A*. On November 19, 1975, in a final liquidating distribution, the remainder of *X*'s assets having a fair market value of $37x$ dollars was distributed to *A*. As of November 19, 1975, without regard to the liquidating distributions, *X* had 1975 taxable income and current earnings and profits of $4x$ dollars. *X* made no other distributions during 1975.

Section 1.1373-1(a) of the Income Tax Regulations provides that each person who is a shareholder of an electing small business corporation on the last day of the corporation's taxable year must include in gross income the amount the shareholder would have received as a dividend if on such last day the corporation distributed pro rata to its shareholders an amount of money equal to its undistributed taxable income for the corporation's taxable year. The amount of this constructive distribution is determined in accordance with section 316 of the Code, and increases the shareholders' basis for their stock under section 1376(a). These rules apply also in respect of the short taxable year in which the corporation is liquidated. See Example (6) in section 1.1373-1(g).

Section 1.1375-4(b) of the regulations provides that actual distributions of money by an electing small business corporation that are in exchange for stock cannot be considered distributions of a shareholder's net share of previously taxed income.

Under section 1.333-4 of the regulations amounts received by a qualified electing shareholder of a corporation liquidated pursuant to section 333 of the Code are treated as received in exchange for stock as provided in section 331, and gain recognized from the receipt of such amounts is determined under section 1001. Gain or loss must be computed separately on each share of stock owned by a qualified electing shareholder. If certain stock and securities are not distributed in the liquidation, the gain recognized by a qualified electing shareholder is the greater of the money received or the shareholder's ratable share of accumulated earnings and profits as of the last day of the month of liquidation without diminution by distributions during such month. If the qualified electing shareholder is not a corporation, to the extent of such ratable share of accumulated earnings and profits, the gain is taxable as a dividend and the gain in excess of such ratable share is treated as short-term or long-term capital gain, as the case may be.

Accordingly, under section 1.1373-1(a) of the regulations, *X*'s 1975 taxable income of $4x$ dollars must be included in *A*'s gross income for 1975 as a constructive distribution of undistributed taxable income. Also, under the rules contained in section 1.373-1(e), the earnings and profits of the taxable year, $4x$ dollars, are allocated to this constructive distribution, and do not become part of the accumu-

lated earnings and profits of X. As a result of such constructive distribution A's basis for the stock in X is increased from $30x$ dollars to $34x$ dollars.

Since, as provided by section 1.333-4 of the regulations, the cash and property distributed in the liquidation are treated as received in exchange for stock, pursuant to section 1.1375-4(b) no portion of the cash distribution of $13x$ dollars is a distribution of A's net share of previously taxed income.

Thus, on the liquidation A realized gain of $16x$ dollars, this is, the excess of the cash and fair market value of the other assets received, $50x$ dollars, over A's basis for the X stock, $34x$ dollars. Under section 333(e) of the Code, since the amount of cash distributed, $13x$ dollars, exceeds A's ratable share of X's accumulated earnings and profits of $5x$ dollars, A has a recognized gain of 13x dollars. The gain of $5x$ dollars, which is the amount of A's ratable share of X's accumulated earnings and profits, is treated as a dividend, and $8x$ dollars, the remainder of the gain, is treated as long-term capital gain. Under section 334(c), A's basis for the other property received in the liquidation is $34x$ dollars, that is, A's basis for the X stock, $34x$ dollars, decreased by the amount of money received, $13x$ dollars, and increased by the gain recognized, $13x$ dollars.

If the facts were the same except that, instead of distributing the $13x$ dollars of cash to A pursuant to the plan of liquidation, X distributed the cash to A in 1975 prior to the adoption of the plan of liquidation, the consequences of the transaction would be as follows. Under section 1.1373-1(d) of the regulations the $4x$ dollars of earnings and profits for 1975 would be allocated to the distribution and included in A's gross income for 1975 as a dividend from current earnings and profits. Under section 1.1375-4 the remaining $9x$ dollars distributed would be considered a distribution of previously taxed income and would reduce A's basis for the stock in X from $30x$ dollars to $21x$ dollars; the earnings and profits of X would not be reduced on account of this distribution of previously taxed income. On the liquidation A would realize a gain of $16x$ dollars, that is, the excess of the fair market value of the assets received as a liquidation distribution, $37x$ dollars, over A's basis for the X stock, $21x$ dollars. Under section 333(e) of the Code, since no cash would be distributed in the liquidation, A's recognized gain would be limited to $5x$ dollars, the amount of A's ratable share of X's accumulated earnings and profits, and this gain would be treated as a dividend. Under section 334(c), A's basis for the property received in the liquidation would be $26x$ dollars, that is, A's basis for the X stock, $21x$ dollars, increased by the gain recognized, $5x$ dollars.

Subchapter T.—Cooperatives and Their Patrons
Part I.—Tax Treatment of Cooperatives

Section 1381.—Organizations to Which Part Applies

26 CFR 1.1381-1: Organizations to which part applies.

Whether either section 46(e)(1)(C) of the Code or section 48(a)(4) applies to a corporate lessor who leases "section 38 property" to a nonexempt cooperative organization. See Rev. Rul. 76-260, page 5.

Chapter 2.—Tax on Self-Employment Income

Section 1402.—Definitions

26 CFR 1.1402(a)-1: Definition of net earnings from self-employment.

Farmers; partial cancellation of indebtedness to F.H.A. The cancelled portion of an emergency loan granted by the Farmers Home Administration to a farmer who suffered an uninsured drought loss to the farmer's growing crops, in which the farmer had no adjusted basis at the time of loss, is includible in computing net earnings from self-employment; Rev. Rul. 73-408 amplified.

Rev. Rul. 76-500

Advice has been requested as to the treatment, for purposes of the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954), of emergency loan cancellations under the circumstances described below.

Rev. Rul. 73-408, 1973-2 C.B. 15, holds that the cancelled portion of an emergency loan granted to a farmer by the Farmers Home Administration is includible in the farmer's gross income.

The facts in Rev. Rul. 73-408 are that, as a result of a drought in a farming area in 1972, a farmer suffered an uninsured crop loss in the amount of $8,000. At the time of the crop loss, the farmer had no adjusted basis in the growing crops. Shortly thereafter, the farmer was granted an $8,000 emergency loan by the Farmers Home Administration pursuant to the provisions of the Consolidated Farmers Home Administration Act of 1961, as amended, 7 U.S.C. 1961-1967.

At the time the loan was granted, the Farmers Home Administration cancelled $5,000 of the principal of the loan. The cancellation was authorized by section 5 of Pub. L. 92-385, 86 Stat. 554, which amended the foregoing Act. Section 5 stated that the Secretary of Agriculture shall cancel up to $5,000 of the principal of a loan made in connection with a loss resulting from a major or natural disaster (including drought) that occured after June 30, 1971, and before July 1, 1973, where the loss or damage is not compensated for by insurance or otherwise. (See Pub. L. 93-24, 87 Stat. 24, enacted April 20, 1973, which repealed the above loan cancellation provisions in section 5 of Pub. L. 92-385.)

Section 1402(a) of the Act provides that the term "net earnings from self-employment" means the gross in-

come derived by an individual from any trade or business that the individual carries on, less the allowable deductions that are attributable to such trade or business.

Rev. Rul. 73-408 states that the purpose of the loan cancellation provisions of Pub. L. 92-385 is to provide disaster victims, including farmers, with compensation for their otherwise uncompensated disaster losses. Such a loan cancellation, when made in connection with the crop production loss suffered by the farmer has the substantive effect of providing the farmer with compensation for the loss of future profits or potential income that would have been included in gross income absent the disaster.

Accordingly, the amount of the cancelled portion of the loan represents a replacement of a portion of a farmer's lost profits and must be taken into account in computing net earnings from self-employment for purposes of the tax on self-employment income.

Rev. Rul. 73-408 is amplified.

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26 CFR 1.1402(e)-2A: Ministers, members of religious orders and Christian Science practitioners; application for exemption from self-employment tax.

Exemption; minister of church. A duly ordained, commissioned, or licensed minister of a church may, on religious grounds, be granted an exemption from social security coverage and the self-employment tax provided the minister is able to establish that the church qualifies for exemption as a religious organization described in section 501(c)(3) of the Code.

Rev. Rul. 76-415

A duly ordained, commissioned, or licensed minister of a church may, on religious grounds, and pursuant to section 1402(e) of the Internal Revenue Code of 1954, request and be granted an exemption from social security coverage and from the self-employment tax attributable to such coverage, provided application for the exemption is filed within the time limits prescribed in section 1402(e)(2) and the regulations thereunder.A minister may apply for exemption by filing Form 4361, Application for Exemption From Self-Employment Tax For Use by Ministers, Members of Religious Orders and Christian Science Practitioners.

Held, for the purpose of filing a Form 4361, an ordained, commissioned or licensed minister of a church is eligible to exercise the election contained in section 1402(e) of the Code only if the minister is able to establish that the church qualifies as an organization exempt from income tax under section 501(a) as a religious organization described in section 501(c)(3).

Chapter 3.—Withholding of Tax on Nonresident Aliens and Foreign Corporations and Tax-Free Covenant Bonds
Subchapter A.—Nonresident Aliens and Foreign Corporations

Section 1441.—Withholding of Tax On Nonresident Aliens

26 CFR 1.1441-1: Requirement for withholding of tax on nonresident aliens, foreign partnerships and foreign corporations.

Whether the gross income of a domestic corporation, the assets of which were acquired in a statutory merger, should be taken into account by the surviving corporation with respect to pre-merger years, in applying the source of income tests of section 861(a)(1)(B) and section 861(a)(2)(A) of the Code. See Rev. Rul. 76-300, page 217.

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26 CFR 1.1441-6: Withholding pursuant to the application of a tax treaty which confers a reduced rate of, or an exemption from, United States income tax.

Whether distributions made to nonresident alien partners that are taxable as dividends are subject to withholding at the rate specified under the tax treaty. See Rev. Rul. 76-435, page 490.

Section 1442.—Withholding of Tax On Foreign Corporations

26 CFR 1.442-1: Withholding of tax on foreign corporations.

Whether the gross income of a domestic corporation, the assets of which were acquired in a statutory merger, should be taken into account by the surviving corporation with respect to pre-merger years, in applying the source of income tests of section 861(a)(1)(B) and section 861(a)(2)(A) of the Code. See Rev. Rul. 76-300, page 217.

Chapter 6.—Consolidated Returns
Subchapter A.—Returns and Payment of Tax

Section 1502.—Regulations

26 CFR 1.1502-13: Intercompany transactions.

Whether the listing of intercompany interest under the heading of deferred intercompany interest on a schedule attached to a consolidated Federal income tax return is considered to be an election to capitalize such interest pursuant to section 266 of the Code. See Rev. Rul. 76-325, page 88.

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26 CFR 1.1502-14: Stock, bonds, and other obligations of members.

Whether dividends received by a parent corporation from its wholly owned life insurance company subsidiary should be treated as personal holding company income under the circumstances described. See Rev. Rul. 76-320, page 181.

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26 CFR 1.1502-14: Stock, bonds, and other obligations of members.

Whether section 1.1502-14(d) of the regulations (dealing with stocks, bonds, and other obligations of members) operates to defer and not currently allow a deduction for an addition to a reserve for bad debts under section 166(c) of the Code computed under section 585(b)(2). See Rev. Rul. 76-430, page 183.

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26 CFR 1.1502-33: Earnings and profits.

The effect of an intercompany agreement upon the earnings and profits of each member of an affiliated group that files a consolidated return. See Rev. Rul. 76-302, page 257.

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26 CFR 1.1502-75: Filing of consolidated returns.
(Also Sections 1504, 6072, 6081; 1.1504-1, 1.6072-2, 1.6081-1, 301.6081-1.)

Election to file consolidated return; separate return by parent. An affiliated group, whose parent inadvertently filed a separate return for its taxable year, is prevented from

filing a consolidated return for the same year after the due date of the parent's return. The relief provisions of section 1.1502-75(b)(3) of the regulations are inapplicable. Rev. Rul. 56-67 distinguished.

Rev. Rul. 76-393

Advice has been requested whether the filing of a separate Federal income tax return by the parent corporation of an affiliated group of corporations under the circumstances described below prevents the filing of a consolidated Federal income tax return by such group.

P, a domestic corporation, is the common parent of an affiliated group of corporations within the meaning of sections 1501 and 1504(a) of the Internal Revenue Code of 1954. Such group consists of *P* and its wholly owned domestic subsidiaries, *S-1* and *S-2*, all of which were incorporated in January 1973, and operate on a calendar year basis for Federal income tax purposes.

P filed a separate Federal income tax return for the 1973 calendar year on March 15, 1974, the due date of such return. *P* had not requested and did not receive an extension of time to file its return pursuant to section 6081 of the Code and the regulations thereunder. However, *S-1* and *S-2* received 6-month extensions of time until September 15, 1974, to file their 1973 separate returns.

Subsequent to March 15, 1974, and prior to September 15, 1974, *S-1* and *S-2* discovered that *P* had inadvertently failed to file a consolidated return for the group but instead filed a separate return for 1973 although all three members of the affiliated group had intended that a consolidated return be filed for 1973.

Section 1501 of the Code provides, in part, that an affiliated group of corporations shall have the privilege of making a consolidated return with respect to its Federal income tax in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations that at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent.

Section 1.1502-75(h)(1) of the Income Tax Regulations provides, in part, that the consolidated return shall be made on Form 1120, U.S. Corporation Income Tax Return, for the affiliated group by the common parent corporation.

Section 1.1502-75(a)(1) of the regulations provides, in part, that a consolidated return must be filed not later than the last day prescribed by law (including extensions of time) for the filing of the common parent's return.

Section 6072(b) of the Code provides, in part, that returns of corporations made on the basis of the calendar year shall be filed on or before the 15th day of March following the close of the calendar year.

Section 6081(a) of the Code provides, in part, that the Secretary or the Secretary's delegate may grant a reasonable extension of time for filing a return. However, with an exception not relevant here, no such extension shall be for more than 6 months.

Consequently, in the instant case, *P*'s 1973 separate return as well as the affiliated group's consolidated return were due on March 15, 1974, notwithstanding that *S-1*'s and *S-2*'s 1973 separate returns were not due until September 15, 1974, because of the 6 month extensions of their March 15, 1974 due dates.

Section 1.1502-75(b)(1) of the regulations provides, in part, that a corporation shall be deemed to have joined in the making of a consolidated return if it files a Form 1122, Authorization and Consent of Subsidiary Corporation to be included in a Consolidated Income Tax Return, in the manner specified in section 1.1502-75(h)(2).

Section 1.1502-75(h)(2) of the regulations provides, in part, that if a group that did not file a consolidated return for the immediately preceding taxable year wishes to file a consolidated return for the taxable year, a Form 1122 must be executed by each subsidiary, and attached to the consolidated return for such year.

However, if the Forms 1122 have not been timely filed, relief is provided in section 1.1502-75(b)(3) of the regulations. Section 1.1502-75(b)(3) provides, in part, that if any member of the affiliated group has failed to join in the making of the consolidated return, the tax liability of each member of the group shall be determined on the basis of separate returns unless the common parent establishes to the satisfaction of the Commissioner of Internal Revenue that such failure was due to a mistake of law or fact, or to inadvertence. In such case, such member shall be treated as if it had filed a Form 1122 for such year.

However, in the instant case, because the provisions of section 1.1502-75(b)(3) of the regulations presuppose the timely filing of a consolidated return by the common parent of the affiliated group, and because *P*, the common parent of *S-1* and *S-2*, did not file a consolidated return by its March 15, 1974 due date, relief under section 1.1502-75(b)(3) is not available.

In addition, Rev. Rul. 56-67, 1956-1 C.B. 437, which allows an affiliated group, under certain circumstances, to file a consolidated return after separate returns for its members have been filed, is distinguishable. Rev. Rul. 56-67 provides, in part, that an affiliated group whose members filed separate returns for a taxable year may file a consolidated return on or before the due date of such return notwithstanding the earlier filing of separate returns. However, in the instant case, the March 15, 1974 due date of *P*'s return

determines the due date of the group's consolidated return, and a consolidated return was not filed by March 15, 1974.

Therefore, because the affiliated group in the instant case has not filed a consolidated return prior to the due date of such return, the relief provisions of section 1.1502-75(b)(3) of the regulations are inapplicable, and such group may not report its income on a consolidated basis for the 1973 taxable year. Consequently, the 1973 calendar year tax liability of each member of the group will be determined on the basis of its separate return.

Rev. Rul. 56-67 is distinguished.

Section 1504.—Definitions

26 CFR 1.1504-1: Definitions.

Whether the relief provisions of section 1.1502-75(b)(3) of the regulations are applicable when the common parent of an affiliated group has failed to timely file the group's consolidated return. See Rev. Rul. 76-393, page 255.

26 CFR 1.1504-1: Definitions.

Whether section 1.1502-14(d) of the regulations (dealing with stocks, bonds, and other obligations of members) operates to defer and not currently allow a deduction for an addition to a reserve for bad debts under section 166(c) of the Code computed under section 585(b)(2). See Rev. Rul. 76-430, page 183.

Subchapter B.—Related Rules
Part I.—In General

Section 1552.—Earnings and Profits

26 CFR 1.1552-1: Earnings and profits. (Also Section 1502; 1.1502-33.)

Affiliated corporations; allocation of consolidated tax liability. An affiliated group's allocation of consolidated tax liability among its members for other than Federal income tax purposes, under an intercompany agreement using a method that differs from the method provided in the group's election under section 1.1502-33(d)(3) of the regulations, will not invalidate the group's election. However, the adjustment to the earnings and profits of the members of the group for tax purposes must be determined in accordance with the election.

Rev. Rul. 76-302

Advice has been requested as to the Federal income tax consequences of the intercompany agreement among members of an affiliated group that provides for the allocation of the consolidated tax liability of the group under the circumstances described below.

X, a domestic corporation, is the common parent of an affiliated group (the group), as that term is defined in section 1504 of the Internal Revenue Code of 1954, consisting of *X* corporation, *Y* corporation, and *Z* corporation. *Z* is wholly owned by *Y* and *Y* is wholly owned by *X*. The group filed its first consolidated Federal income tax return for the calendar year 1972 and therein made a proper election under section 1.1502-33(d)(3) of the Income Tax Regulations to allocate its tax liability under section 1.1552-1(a)(2) in conjunction with section 1.1502-33(d)(2)(ii). The group chose to allocate 100 percent of the additional amounts determined in accordance with section 1.1502-33(d)(2)(ii)(*b*). The group also elected to adjust earnings and profits currently as required by section 1.1502-33c)(4)(iii).

The following schedule shows the amounts of income or loss of each member of the group for the calendar year 1972 at the normal tax rate of 22 percent and illustrates the allocations and the payments that are required to be made among the members in accordance with their elected allocation method.

	Taxable income	Allocation of consolidated tax liability sec. 1.1552-1(a)(2)	Allocation of additional amount under section 1.502-33(d)(2)(ii)	Total tax allocated
	(dollars)	(dollars)	(dollars)	(dollars)
X	200*x*	11*x*	33*x*	44*x*
Y	200*x*	11*x*	33*x*	44*x*
Z	(300*x*)		(66*x*)	(66*x*)
Consolidated Amounts	100*x* dollars	22*x* dollars	*0* dollars	22*x* dollars

The above schedule shows that *X* and *Y* are each allocated 11*x* dollars of the consolidated tax liability under section 1.1552-1(a)(2) of the regulations and an additional amount of 33*x* dollars under section 1.1502-33(d)(2)(ii), a total of 44*x* dollars each. The additional amount allocated to *Z* results in a credit of 66*x* dollars to *Z*'s earnings and profits.

However, pursuant to the intercompany agreement, *Y* and *Z* were to be treated as a unit and any additional amounts determined under sections 1.1502-33(d)(2)(ii)(*b*) or (*c*) of the regulations were to be combined for the purpose of computing the additional amount to be allocated to them as a unit. The agreement further provided that in the event the allocation resulted in a credit to *Y* and *Z* as a

unit, the transfer of funds would be made by X to Y and Y would retain the funds as its own. Thus, X transferred to Y $33x$ dollars due Y and Z as a unit under the agreement. Y paid X $11x$ dollars as its allocable share and X paid the consolidated tax liability of $22x$ dollars as agent for the group. The earnings and profits of X, Y, and Z prior to the allocation of tax liability were in the respective amounts of $600x$ dollars, $500x$ dollars, and $400x$ dollars.

The specific questions are: (1) what effect, if any, does the intercompany agreement have on the allocation method for income tax purposes; and (2) what effect does the intercompany agreement have on the earnings and profits of each member of the group.

Section 1552(a)(2) of the Code contains one of the methods of allocating the tax liability among members of an affiliated group, for purposes of determining such member's earnings and profits, and provides that the tax liability of the group shall be allocated to the several members of the group on the basis of the percentage of the total that the tax of such member if computed on a separate return would bear to the total amount of the taxes for all members of the group so computed.

Section 1.1502-33(d)(2)(ii) of the regulations contains a method of allocating the tax liability of the group allocation under section 1552 of the Code, an additional amount shall be allocated to each member equal to a fixed percentage that does not exceed 100 percent of the excess, if any, of (1) the separate return tax liability of such member for the taxable year, over (2) the tax liability allocated to such member in accordance with section 1552. Section 1.1502-33(d)(1) provides that allocations of tax liability of the group made in accordance with section 1.1502-33(d)(2) shall be treated as allocations of the tax liability of the group for taxable years beginning after December 31, 1965, even though the sum of the amounts allocated for a taxable year exceeds the tax liability of the group as determined under section 1.1552-1(b)(1).

Section 1.1552-1(b)(2) of the regulations provides, in part, that the amount of tax liability allocated to a corporation as its share of the tax liability of the group shall (i) result in a decrease in the earnings and profits of such corporation in such amount, and (ii) be treated as a liability of such corporation for such amount. If the full amount of such liability is not paid by such corporation, pursuant to an agreement among the members of the group or otherwise, the amount that is not paid will generally be treated as a distribution with respect to stock, a contribution to capital, or a combination thereof, as the case may be.

Section 1.1502-33(d)(2)(ii)(*c*) of the regulations provides, in part, that the total of additional amounts allocated pursuant to section 1.1502-33(d)(2)(ii)(*b*) shall be credited to the earnings and profits of those members that had items of income, deductions or credits to which such total is attributable.

An election under section 1.1502-33(d)(3) of the regulations of a method of allocating the tax liability of the group under section 1.1502-33(d)(2) is not conditioned upon the use of such method of allocation for purposes other than the Internal Revenue Code. *See* section 1.1552-1(b)(2) and example (2) of section 1.1502-33(d)(4). Therefore, the above described intercompany agreement that allocates the additional amount among X, Y, and Z in a different manner than under the group's section 1.1502-33(d)(2)(ii) election, will not invalidate such election. However, the adjustment to the earnings and profits of the members of the group for tax purposes must be determined in accordance with the election under section 1.1502-33(d)(2)(ii).

Accordingly, under the facts of the instant case:

(1) the earnings and profits of X and Y will each be reduced by $44x$ dollars representing their respective shares of the consolidated tax liability and the additional amounts as determined under sections 1.1502-33(d)(2)(ii)(*a*) and (*b*) of the regulations;

(2) the earnings and profits of Z will be increased in accordance with section 1.1502-33(d)(2)(ii)(*c*) of the regulations by $66x$ dollars;

(3) the transfer of $33x$ dollars by X to Y will be considered as a payment by X of its $33x$ dollars liability to Z and Y will be considered to have constructively received a dividend of $33x$ dollars from Z; and

(4) the failure of Y to pay the amount of its liability to Z results in a dividend from Z to Y in the amount of 33x dollars. *See* section 1.1552-1(b)(2) of the regulations.

See Rev. Rul. 73-605, 1972-2 C.B. 109, which concerns the tax consequences of an agreement among members of an affiliated group that provided for allocation of the consolidated tax liability in accordance with section 1552(a)(2) of the Code, computation of a hypothetical tax for each member on a separate return basis, and the payment, through the parent corporation from members whose hypothetical tax was reduced, to members whose losses or credits generated such reductions.

It should be noted that, under the facts of Rev. Rul. 73-605, it was not the computation of a hypothetical tax that resulted in an increase (or decrease) of a member's earnings and profits but rather the receipt (or payment) of such amount. However, in the instant case a member's earnings and profits are increased or decreased, as the case may be, by the additional amount allocated under section 1.1502-33(d)(2)(ii)(*b*) of the regulations even though such amount is not

received or paid in accordance with the allocation.

Part II.—Certain Controlled Corporations

Section 1563.—Definitions and Special Rules

26 CFR 1.1563-1: Definition of controlled group of corporations and component members.

Whether a mutual savings bank that conducts a life insurance business in a separate department is entitled to compute the alternative tax for such organizations under section 594 of the Code, utilizing the surtax exemptions under section 11(d) in determining both the partial tax on the income of the insurance department and the partial tax on the income of the banking department, before adding the two partial taxes to determine the overall tax under section 594. See Rev. Rul. 76-476, page 184.

Subtitle B.—Estate and Gift Taxes
Chapter 11.—Estate Tax
Subchapter A.—Estates of Citizens or Residents
Part I.—Tax Imposed

Section 2001.—Imposition and Rate of Tax

26 CFR 20.2001-1: Rate of tax.

Whether Treasury bonds may be redeemed at par value in an amount equal to the Federal estate tax liability before an applicable credit for gift tax paid. See Rev. Rul. 76-367, below.

Part II.—Credits Against Tax

Section 2012.—Credit for Gift Tax

26 CFR 20.2012-1: Credit for gift tax. (Also Section 2001; 20.2001-1.)

U.S. Treasury bonds redeemed to pay tax; gift tax credit. The maximum combined par value of eligible Treasury bonds that may be redeemed for the purpose of paying the estate's Federal estate tax liability is an amount equal to the net Federal estate tax due after all applicable credits, including the credit for Federal gift taxes paid, have been subtracted from the amount of tax imposed under section 2001 of the Code.

Rev. Rul. 76-367

A decedent's Federal gross estate includes several U.S. Treasury bonds that may be redeemed at par value for the purpose of paying the Federal estate tax liability of the estate. A credit for Federal gift taxes paid by the decedent with respect to property includible in the gross estate is allowable to the estate under section 2012 of the Internal Revenue Code of 1954.

Held, the maximum combined par value of eligible Treasury bonds that may be redeemed for the purpose of paying the estate's Federal estate tax liability is an amount equal to the net Federal estate tax due after all applicable credits, including the credit for Federal gift taxes paid, have been subtracted from the amount of tax imposed under section 2001 of the Code.

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26 CFR 20.2012-1: Credit for gift tax.

Credits; gift tax; reacquired property. No gift tax credit is allowable under section 2012 of the Code for gift taxes paid by the donor-decedent on inter vivos gifts of property subsequently reacquired by purchase, bequest, or the death of a joint tenant.

Rev. Rul. 76-470

Advice has been requested whether, under the circumstances described below, a gift tax credit is allowable under section 2012 of the Internal Revenue Code of 1954 for gift taxes paid by the donor-decedent on inter vivos gifts of property subsequently included in the decedent's gross estate under section 2033.

In 1965, the decedent made an inter vivos gift of real property (Blackacre) to *A* and paid a Federal gift tax on the transfer. During the same year, the decedent made another inter vivos gift of other real property (Whiteacre) to *B* and paid a Federal gift tax on that transfer. The following year, the decedent, with individually owned funds, purchased a parcel of real property (Greenacre) and had it titled in the decedent's name and that of *C* as joint tenants with right of survivorship. The decedent paid a Federal gift tax with respect to the creation of the joint tenancy.

In 1974, *A* died and bequeathed Blackacre to the decedent. In 1975, the decedent purchased Whiteacre from *B* for its then fair market value. Also, in 1975, *C* died and the decedent became the owner of the entire interest in Greenacre by right of survivorship. The decedent died in 1976 still owning Blackacre, Whiteacre and Greenacre. All three parcels were included in the decedent's gross estate under 2033 of the Code.

With respect to gifts made prior to January 1, 1977, section 2012(a) of the Code provides as follows:

> If a tax on a gift has been paid under chapter 12 * * *, and thereafter on the death of the donor any amount in respect of such gift is required to be included in the value of the gross estate of the decedent for purposes of this chapter, then there shall be credited against the tax imposed by section 2001 the amount of the tax paid on a gift under chapter 12 * * * with respect to so much of the property which constituted the gift as is included in the gross estate, except that the amount of such credit shall not exceed an amount [of the estate tax which results from including that property in the gross estate].

Interests in probate property that a decedent beneficially owns at the date of death, and which are transferable at death by the decedent's will or by state intestacy laws, are includible in the gross estate under section 2033 of the Code. Interests in property that the decedent gratuitously transferred to others before death and on which Federal gift taxes may have been paid, and thus which the decedent did not beneficially own at the date of death and which may have already been subject to a transfer tax, may nevertheless be included in the decedent's gross estate as having been transferred in contemplation of death (section 2035) or because certain powers or interests

were reserved by the decedent at the time of the transfer (sections 2036, 2037 and/or 2038).

Since the transfer of the same property interests may be taxed under both the Federal gift tax and the Federal estate tax, an estate is entitled, with certain limitations, to a credit under section 2012 of the Code for gift taxes paid in respect of transferred property that is subsequently included in the gross estate for Federal estate tax purposes.

The gift tax credit, however, applies only if the double taxation derives from interests in nonprobate property directly includible in the decedent's gross estate. That is to say: the credit does not apply with respect to interests in property that the decedent transferred before death, the beneficial interest in which was completely and absolutely revested in the decedent before death so that such interests are required to be included in the gross estate under section 2033 of the Code. This conclusion is evident from the language of section 2012 (quoted above) providing for the gift tax credit where "a tax on a gift has been paid * * * and thereafter on the death of the donor any amount *in respect of such gift* is required to be included in the value of the gross estate of the decedent * * *." (Emphasis added.) See *Commissioner v. Hart,* 106 F. 2d 269 (3rd Cir. 1939).

Accordingly, even though Federal gift taxes were previously paid by the decedent in respect of the properties includible in the decedent's gross estate, no gift tax credit is allowable under section 2012 of the Code against the decedent's Federal estate tax liability attributable to the includibility of such properties because they are includible under section 2033 solely by reason of the decedent's absolute ownership.

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26 CFR 20.2012-1: Credit for gift tax.

Credits; gift tax; tenants by the entirety. The gift tax paid by a decedent on the transfer, in contemplation of death and without consideration, of real property that was purchased with separate funds and titled to the decedent and his or her spouse as tenants by the entirety is divided equally between the decedent's estate and the spouse's estate for purposes of computing the credit allowable under section 2012 of the Code, even though decedent paid no gift tax at the time the property was purchased.

Rev. Rul. 76-471

Advice has been requested regarding the treatment, under the circumstances described below, of the gift tax credit allowable under section 2012 of the Internal Revenue Code of 1954 with respect to gifts made prior to January 1, 1977.

In 1961, *A*, with individually owned funds, purchased a parcel of real property located in State *X*, and had it titled in the names of *A* and *B* (*A*'s spouse) as tenants by the entirety. Pursuant to section 2515(a) of the Code, *A* did not elect to report a gift to *B* at the time they took title to the property as tenants by the entirety.

Under the law of State *X*, where *A* and *B* resided and where the real property was located, a tenancy by the entirety cannot be severed by either spouse acting alone, and each spouse is entitled to one-half of the income from such property. In 1975, *A* and *B*, both of whom were suffering from incurable cancer, pursuant to an estate planning arrangement, gratuitously transferred the real property to their children. For Federal gift tax purposes, the transfer was reported as wholly a gift by *A*, who paid the Federal gift tax. Nine months after the transfer, both *A* and *B* died of incurable cancer.

Section 2035 of the Code provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, in contemplation of the decedent's death.

With respect to gifts made prior to January 1, 1977, section 2012(a) of the Code provides as follows:

> If a tax on a gift has been paid under chapter 12 * * *, and thereafter on the death of the donor any amount in respect of such gift is required to be included in the value of the gross estate of the decedent for purposes of this chapter, then there shall be credited against the tax imposed by section 2001 the amount of the tax paid on a gift under chapter 12 * * * with respect to so much of the property which constituted the gift as is included in the gross estate, except that the amount of such credit shall not exceed an amount [of the estate tax which results from including that property in the gross estate].

Since, under the law of State *X*, *A* and *B* are each deemed to have acquired a half interest in the property at the time the tenancy by the entirety was created, one-half the value of the property transferred within three years of *B*'s death, in furtherance of an estate planning arrangement, is includible in *B*'s gross estate under section 2035 of the Code, notwithstanding the Federal gift tax election made by *A* to not report a gift to *B* at the time they initially took title to the property as tenants by the entirety. *See* Rev. Rul. 76-348, page 267, this Bulletin. The remaining one-half of the transferred property is includible in *A*'s gross estate under section 2035.

Section 2012 of the Code and section 20.2012-1(a) of the Estate Tax Regulations provide for a credit against the Federal estate tax for a gift tax paid on a gift by the decedent of property subsequently included in the gross estate of the decedent. Thus, neither the Code nor the regulations specifically preclude the applicability of the gift tax credit where the gift tax was paid by someone other than the donor. In addition, since section 2012 was enacted to avoid the double tax which results if both a gift tax and estate tax are paid

on the same item of property (65 *Cong. Rec.* 3121 (1924)), the purpose of the section would be obstructed if the credit was limited to situations in which the gift tax was paid by the donor. Moreover, the general principle that the deductions or credits for taxes paid are available only to the person who paid the tax is not applicable to the credit against the estate tax for gift taxes paid. *See* Rev. Rul. 74-363, 1974-2 C.B. 290 (where the gift tax was paid by the donee), and Rev. Rul. 74-533, 1974-2 C.B. 293 (where the gift tax was paid by the creator of a reciprocal trust).

Accordingly, even though all of the gift tax was paid by *A* in the instant case, a gift tax credit is allowable against *A*'s Federal estate tax liability under section 2012 of the Code, subject to the applicable limitations, with respect to one-half of the gift tax paid, corresponding to the portion of the transferred property includible in *A*'s gross estate under section 2035; and a separate gift tax credit is also allowable to *B*'s estate under section 2012, subject to the applicable limitations, with respect to the one-half portion of the gift tax paid in respect of the half of the transferred property includible in *B*'s gross estate under section 2035.

Section 2013.—Credit for Tax on Prior Transfers

26 CFR 20.2013-3: "Second limitation."

Credit for tax on prior transfer; computation. For purposes of computing the limitation on the credit for tax on prior transfers prescribed in section 2013(c)(1) of the Code for an estate having both community and separate property, the adjusted gross estate for the reduced estate is determined by subtracting from the reduced gross estate: (1) an amount that bears the same ratio to the entire value of the reduced gross estate that all of the community property bears to the entire gross estate, and (2) an amount that bears the same ratio to the aggregate of the deductions allowed under sections 2053 and 2054 that the value of all of the separate property bears to the entire gross estate.

Rev. Rul. 76-311

Advice has been requested as to the proper method of computing the limitation on the credit for tax on prior transfers prescribed in section 2013 (c)(1) of the Internal Revenue Code of 1954, under the circumstances described below.

In 1971 *A*'s parent died, bequeathing shares of stock in two corporations to *A*. In the parent's Federal estate tax return the shares of stock in *Y* Corporation were valued at $200,000, and the shares in *Z* Corporation were valued at $25,000. A Federal estate tax was paid with respect to the parent's estate.

A made a gift of the *Y* Corporation stock to charity in 1971. In 1975 *A* died testate. By the terms of the will, all of *A*'s separate property and *A*'s one-half share of community property was devised and bequeathed to *A*'s surviving spouse. Included among *A*'s separate property at the date of death were the shares of *Z* Corporation that *A* had inherited from *A*'s parent.

In the Federal estate tax return filed for *A*, the *Z* Corporation stock was valued at $40,000. Other separate property in the estate amounted to $60,000. The balance of the gross estate consisted of community property worth $900,000. Deductible debts and expenses were $50,000.

Section 2013 of the Code provides, in general, that the estate of a decedent is allowed a credit for the estate tax paid on property transferred to the decedent from a transferor who died within ten years before, or within two years after, the decedent's death. The amount of the credit allowable for the transferred property is limited to the lesser of the transferor's or the transferee's Federal estate tax paid with respect to such property.

The second limitation, the amount of transferee's Federal estate tax attributable to the transferred property, is determined in accordance with section 2013(c)(1) which provides:

> The credit provided in this section shall not exceed the amount by which—
>
> (A) the estate tax imposed by section 2001 or section 2101 (after deducting the credits for State death taxes, gift tax, and foreign death taxes provided for in sections 2011, 2012, and 2014), computed without regard to this section, exceeds
>
> (B) such tax computed by excluding from the decedent's gross estate the value of such property transferred and, if applicable, by making the adjustment hereinafter indicated.
>
> If any deduction is otherwise allowable under section 2055 or section 2106(a)(2) (relating to charitable deduction) then, for the purpose of the computation indicated in subparagraph (B), the amount of such deduction shall be reduced by that part of such deduction which the value of such property transferred bears to the decedent's entire gross estate reduced by the deductions allowed under sections 2053 and 2054, or section 2106(a)(1) (relating to deduction for expenses, losses, etc.). * * *.

Section 20.2013-1(a) of the Estate Tax Regulations states that " * * * There is no requirement that the transferred property be identified in the estate of the present decedent or that the property be in existence at the time of the decedent's death. * * *" If the property was included in the gross estate of the transferor and a Federal estate tax was paid thereon, the credit for tax on prior transfers may be applied to the interest receivable by the transferee, irrespective of whether the interest is includible in the transferee decedent's Federal gross estate. See Rev. Rul. 59-9, 1959-1 C.B. 232, which holds that the allowance of the section 2013 credit for an inherited life estate is to be based on the life estate's value in the estate of the transferor, without regard to the amount of income actually received by the transferee life tenant.

In the instant case, the amount to be used in computing the prior transfer credit is the value of the shares of

stock in the two corporations, determined as of the date of the transferor's death, notwithstanding the fact that some of the shares of stock are not includible in the transferee's gross estate or that the fair market value of the stock has changed since the date of the transferor's death.

Rev. Rul. 60-161, 1960-1 C.B. 367, holds that the provisions of section 2056(c)(1) of the Code, limiting the marital deduction to one-half the adjusted gross estate, are applicable to the computation of the tax on the reduced taxable estate under section 2013(c)(1)(B). In cases that do not involve community property, the adjusted gross estate for the reduced estate is determined by subtracting from the reduced gross estate the aggregate of the deductions allowed by sections 2053 and 2054 of the Code.

A special rule under section 2056(c)(2)(B) of the Code, for computing the adjusted gross estate in cases involving community property, provides that the adjusted gross estate is determined by subtracting from the gross estate: the value of the "community property" (as defined in section 2056) and an amount which bears the same ratio to the aggregate of the deductions under sections 2053 and 2054 which the noncommunity property bears to the entire gross estate.

The computation of the adjusted gross estate for the reduced estate under section 2013 of the Code must take account of community property in the transferee's gross estate. However, since section 2013 does not require the transferred property to be traced into, or otherwise identified in, the transferee's estate, neither the community property nor the separate property in the transferee's estate is to be specifically characterized as transferred property in computing the adjusted gross estate for the reduced estate. For purposes of section 2013(c)(1)(B), the ratio of the separate property in the reduced gross estate to the entire reduced gross estate is considered to be the same as the ratio described in section 2056(c)(2)(B)(iv) of the Code. The amount of community property in the reduced gross estate can also be expressed in terms of a ratio.

Accordingly, the adjusted gross estate for the reduced estate is determined by subtracting from the reduced gross estate (1) an amount that bears the same ratio to the entire value of the reduced gross estate that all of the community property bears to the entire gross estate and (2) an amount that bears the same ratio to the aggregate of the deductions allowed under sections 2053 and 2054 of the Code that the value of all of the noncommunity property bears to the entire gross estate.

The computation of the reduced taxable estate for *A*'s estate may be illustrated as follows:

Step I

	Total	*Community*	*Separate*
Ratio of values	1.00	.90	.10
Gross estate	$1,000,000	$900,000	$100,000
Less transfers from *A*'s parent	225,000	202,500	22,500
Reduced gross estate	$ 775,000	$697,500	$ 77,500
Less debts and expenses	50,000	45,000	5,000
Reduced adjusted gross estate			$ 72,500
One-half thereof (marital deduction limit)			$ 36,250

Step II

Reduced gross estate		$775,000
Less deductions for reduced gross estate:		
Debts and expenses	$ 50,000	
Marital deduction	36,250	
Exemption	60,000	146,250
Reduced taxable estate		$628,750

Part III.—Gross Estate

Section 2031.—Definition of Gross Estate

26 CFR 20.2031-1: Definition of gross estate; valuation of property.

U.S. Treasury bonds; redeemed to pay estate tax; valuation. The extent to which marketable U.S. Treasury bonds, owned by the decedent at death, may be redeemed and applied at par in payment of estate taxes will be determined at a redemption date designated by the estate representative, who may choose a date on which no interest is accrued to use the maximum amount of bonds, and the bonds will be valued under the provisions of Rev. Rul. 69-489.

Rev. Rul. 76-312

Advice has been requested as to the valuation, for Federal estate tax purposes, of marketable United States Treasury bonds owned by a decedent under the circumstances described below.

The decedent died owning certain marketable, interest bearing United States Treasury bonds that under the terms of their issuance and the governing regulations could be redeemed at the option of the representative of decedent's estate at par value, plus accrued interest to the effective date of

redemption, for the payment of Federal estate taxes. The mean between the highest and lowest quoted selling prices of the bonds at the date of death was less than their par value. The par value of the bonds owned by the decedent at the date of death exceeded the amount of the estate tax liability.

The procedures and instructions relating to the redemption of such Treasury bonds in payment of Federal estate taxes are prescribed in Rev. Proc. 69-18, 1969-2 C.B. 300. Section 3.02 of Rev. Proc. 69-18 provides as follows:

> 02. If a bond is in a denomination too large for application of the entire proceeds in payment of the tax due from the deceased owner's estate, but is not in the lowest authorized denomination, denominational exchange will be permitted so that bonds totaling the denominational amount next lower than the tax liability may be available for such purpose. For example, if a $10,000 4¼ percent Treasury bond, interest payable on May 15 and November 15, was submitted on August 15, in payment of a Federal estate tax liability of $10,000, at which time the accrued interest from the last interest payment date to the redemption date would be $106.25 and the lowest denomination in which such bonds are issued is $500, the bond would be redeemed to the extent of $9,500 par value, with accrued interest of $100.94, and applied toward payment of the tax liability. A $500 denomination bond would be reissued for the portion of the bond which could not be applied to payment of the tax.

Section 5.01 of Rev. Proc. 69-18 provides, in part, that the date as of which the Treasury bonds are to be redeemed in payment of the estate tax shall be designated by the legal representative of the estate or, if none was appointed, by a person authorized by those entitled to share in the estate. Section 5.02 provides, in part, that redemption may be requested as of the date the Federal estate tax is due or a date prior or subsequent to the date the tax is due.

Section 2031 of the Internal Revenue Code of 1954 provides that the value of the gross estate of the decedent shall be determined by including the value at the time of decedent's death of all property, real or personal, tangible or intangible, wherever situated. Section 20.2031-1(b) of the Estate Tax Regulations provides, in part, that the value of every item of property includible in a decedent's gross estate is its fair market value at the time of the decedent's death.

The valuation of such Treasury bonds, where the amount of the estate tax exceeds the par value of the bonds, is covered in Rev. Rul. 69-489, 1969-2 C.B. 172. That Revenue Ruling concludes that to the extent marketable United States Treasury bonds owned at death may be applied at par in payment of Federal estate taxes, the par value thereof or the mean between their highest and lowest selling prices at the time of decedent's death (and accrued interest to the date of death), whichever is higher, is their "value" or "fair market value" within the meaning of section 2031(a) of the Code and section 20.2031-1(b) of the regulations.

As to bonds in excess of the amount that may be applied at par, the mean quoted selling price thereof (plus accrued interest to the date of the decedent's death) will be the value at which Treasury bonds are includible in a decedent's gross estate for Federal estate tax purposes. Rev. Rul. 69-489 further provides that, except in the case of redemption by substitution, the effective redemption date described in Rev. Proc. 69-18 shall be considered the date the payment is made for purposes of section 6601(a) of the Code.

As illustrated in section 3.02 of Rev. Proc. 69-18, where the described bonds are submitted in payment of a Federal estate tax liability with a requested redemption date other than an interest payment date, the accrued interest from the last interest payment date to the redemption date is added to the denominational amount of the bonds next lower than the tax liability. The lowest denomination in which such bonds are redeemed and reissued is $500. The selection, in the example in section 3.02, by the legal representative of the decedent's estate of a redemption date as of a date when there is no accrued interest on the described bonds will cause a greater amount of the bonds to be redeemed at par value and applied toward payment of the tax liability, and will result in a similar increase in the amount of such bonds to be included in the value of the gross estate at par value. Thus, the accrued interest on such bonds can affect the extent to which eligible bonds may be redeemed at par value.

Because there is at least one day between the decedent's date of death and the date the Federal estate tax is due when there is no interest accrued (since interest payment dates on the described bonds occur on a semiannual basis), the question arises whether the accrued interest is taken into account in determining the maximum amount of the bonds that may be applied toward payment of the tax liability and included in the gross estate at par value.

If, for example, the accrued interest is not to be taken into account, then the $10,000 Treasury bond referred to in section 3.02 of Rev. Proc. 69-18 would be includible in the value of the decedent's gross estate at $10,000 par value plus accrued interest to the date of death notwithstanding the fact that the bond was redeemed only to the extent of $9,500 par value since there existed at least one redemption date between the date of death and the date the tax was due that would permit the full $10,000 par value bond to be redeemed and applied toward payment of the tax liability.

Since Rev. Proc. 69-18 authorizes the representative of the estate to designate the redemption date of the bonds, it would be inconsistent with that prerogative of the representative to disregard the accrued interest solely on the ground that the representative could have designated a date at which time there was no accrued interest.

Accordingly, the determination of the extent to which marketable United

States Treasury bonds owned at death were eligible to be redeemed and applied at par in payment of Federal estate taxes shall be made as of the redemption date designated by the representative of the estate pursuant to Rev. Proc. 69-18, and the value of such bonds is determined in accordance with Rev. Rul. 69-489.

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26 CFR 20.2031-1: Definition of gross estate; valuation of property.

Valuation; remainder interest subject to future diminution. A decedent's vested remainder interest in property as one of a class composed of the issue of the life tenant, the decedent's 53-year old mother, is valued by the formula set forth in section 20.2031-10(d) of the regulations with consideration then given to possible future diminution by reason of decedent's mother bearing or adopting children.

Rev. Rul. 76-472

Advice has been requested as to the proper method of valuing a decedent's remainder interest in property that is subject to diminution due to the possibility of a future increase in the prescribed remainder class.

The decedent's grandparent, *G* a resident of State *Y*, died in 1960. *G* bequeathed a life estate in real property to daughter *M*, with the remainder to the issue of *M*. At the time of *G*'s death, *M* had three children, *A* (the decedent), *B* and *C*. *A* died in 1974 survived by *B*, *C* and *M*. *M* was aged 53 years at the date of decedent's death.

Under the laws of State *Y*, the word "issue" as used in *G*'s will includes all the lawful lineal descendants of *M*, both adopted and natural. Also under the laws of State *Y*, *A* at the date of death had a vested right to a share of the remainder interest in *G*'s real property upon the death of *M*. However, if *M* should have an additional child or children through birth or adoption, such child or children would also share in the remainder interest at *M*'s death, along with *A*'s estate and *B* and *C*. The value of the individual shares of the existing remaindermen would decrease accordingly.

Section 2031 of the Internal Revenue Code of 1954 provides that the value of the gross estate of the decedent shall be determined by including, to the extent provided by law, the value at the time of death of all property, real or personal, tangible or intangible, wherever situated.

Section 20.2031-1(b) of the Estate Tax Regulations provides in part:

> (b) Valuation of property in general. The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value * * *. All relevant facts and elements of value as of the applicable valuation date shall be considered in every case * * *.

Section 20.2031-10(d) of the regulations provides in part:

> (d) Remainders or reversionary interests. If a decedent had, at the time of his death, a remainder or a reversionary interest in property to take effect after an estate for the life of another, the present value of his interest is obtained by multiplying the value of the property by the [appropriate factor from the actuarial tables in section 20.2031-10(f)] * * *.

In general, future interests in property that a decedent owns at death are taxed just as possessory interests. Thus, the value of a vested remainder interest is includible in the value of a remainderman's gross estate under section 2033 of the Code even though the remainderman dies before obtaining possession of the property. See *John G. Frazer*, 6 T.C. 1255 (1946), *aff'd*, 162 F. 2d 167 (3d Cir. 1947); *Utley v. United States*, 290 F. 2d 188 (9th Cir. 1961). If the decedent's vested remainder interest is to take effect upon the termination of the life estate of another, the present value of the decedent's interest is ordinarily ascertainable by use of the actuarial formula set forth in section 20.2031-10(d) of the regulations. However, if the amount of decedent's interest is subject to possible future diminution by reason of the occurrence or nonoccurrence of a contingency, the valuation of such interest does not always lend itself to mere mechanical application of actuarial formulas. *See* Rev. Rul. 61-88, 1961-1 C.B. 417.

In the instant case, the decedent's remainder interest is subject to being diminished by either the birth or adoption of children by *M*. To properly reflect either one of these possible contingencies, the remainder interest should be valued in accordance with the general rules for the valuation of property set forth in section 20.2031-1 (b) of the regulations. *See* Rev. Rul. 67-370, 1967-2 C.B. 324; Rev. Rul. 61-88, 1961-1 C.B. 417.

In making the valuation, the actuarial value of the decedent's remainder interest, ascertained by the formula set forth in section 20.2031-10(d) of the regulations, should be the starting point. Consideration should then be given to all known facts and circumstances that might tend to decrease such value, with due regard for (1) the certainty that a woman who has reached the age of 53 years will not bear children is far greater than that which attends most other human affairs and (2) the unlikelihood that a woman of that age will adopt a child.

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26 CFR 20.2031-2: Valuation of stocks and bonds.
(Also Section 2512; 25.2512-2.)

T.D. 7432

TITLE 26 — INTERNAL REVENUE—CHAPTER I, SUBCHAPTER B, PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954.—Part 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954.

Use of composite listing in evaluating stocks and bonds

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF
INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned

Preamble

This document contains amendments to the Estate Tax Regulations (26 CFR Part 20) under section 2031 of the Internal Revenue Code of 1954, and the Gift Tax Regulations (26 CFR Part 25) under section 2512 of the Internal Revenue Code of 1954. The amendments are designed to require that, when the records of the principal exchange are not available, the published composite listing of transactions on the combined exchanges be relied upon in the evaluation of stocks and bonds for both estate and gift tax purposes.

Section 2031 of the Code relates to the determination of the value of the gross estate of a decedent. Section 2512 of the Code relates to the valuation of gifts. Present regulations under both sections provide that the value of stocks and bonds is their fair market value. Where there is a market on a stock exchange, the fair market value is the mean between the highest and lowest quoted selling prices on the valuation date (for estate taxes) or the date of the gift (for gift taxes). If stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in is required to be employed.

On January 27, 1976, 375 publications of general circulation, including such publications as the Wall Street Journal, began reporting security transactions only by a daily composite listing of the combined exchanges. Consequently, it became impossible to determine from such listing the performance of a stock or bond on its principal exchange. The amended regulations provide that the records of the principal exchange be employed only when they are available in a generally available listing or publication of general circulation. When such records are not available, if the particular stock or bond is reported on a composite listing of combined exchanges available in a generally available listing or publication of general circulation, the amended regulation requires the use of such listing.

Adoption of amendments to the regulations

In order to require that the published composite listing of transactions on the combined exchanges be relied upon in the evaluation of stocks and bonds for both estate and gift tax purposes, the Estate Tax Regulations (26 CFR Part 20) under section 2031 of the Internal Revenue Code of 1954, and the Gift Tax Regulations (26 CFR Part 25) under section 2512 of the Internal Revenue Code of 1954 are amended as follows:

Paragraph 1. Section 20.2031-2(b) is amended by modifying the fourth sentence of subparagraph (1), and adding thereafter a new sentence. This amendment reads as follows:

§ 20.2031-2 Valuation of stocks and bonds.

* * * * *

(b) *Based on selling prices.* (1) * * * If the stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in should be employed if such records are available in a generally available listing or publication of general circulation. In the event that such records are not so available and such stocks or bonds are listed on a composite listing of combined exchanges available in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed.

* * * * *

Par. 2. Section 25.2512-2(b) is amended by modifying the fourth sentence of subparagraph (1), and adding thereafter a new sentence. This amendment reads as follows:

§ 25.2512-2 Stocks and bonds.

* * * * *

(b) *Based on selling prices.* (1) * * * If the stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in should be employed if such records are available in a generally available listing or publication of general circulation. In the event that such records are not so available and such stocks or bonds are listed on a composite listing of combined exchanges available in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed.

* * * * *

Because of the need for immediate guidance with respect to the valuation of stocks and bonds to which this Treasury decision relates, it is found impracticable and unnecessary to issue it with notice and public procedure thereon under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

WILLIAM E. WILLIAMS,
Acting Commissioner of Internal Revenue.

Approved Sept. 3, 1976

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 10, 1976, 8:45 a.m., and published in the issue of the Federal Register for September 13, 1976, 41 F.R. 38769)

Section 2033.—Property in Which Decedent Has an Interest

26 CFR 20.2033-1: Property in which the decedent had an interest.
(Also Section 2040; 20.2040-1.)

Property held as tenants by the entirety; simultaneous deaths. In states that have adopted the Uniform Simultaneous Death Act, a husband and wife are each considered to have survived with respect to one-half of property held by them as tenants by the entirety if it cannot be determined that they died other than simultaneously. In the absence of evidence to indicate the wife furnished any consideration for the property, the entire value of the property is includible in the husband's gross estate and a one-half interest in the wife's gross estate. Rev. Rul. 66-60 modified.

Rev. Rul. 76-303

The Internal Revenue Service has reconsidered the holdings of Rev. Rul. 66-60, 1966-1 C.B. 221, with regard to the includibility of the value of the property held in tenancy by the entirety in the gross estate of the husband and wife.

In Rev. Rul. 66-60, a husband and wife were killed in an automobile accident under circumstances wherein there was not sufficient evidence as to which spouse may have died first. The husband furnished the entire consideration for the purchase of certain realty which was held by them as tenants by the entirety. The husband's will contained no statement as to which should be considered to have survived the other in case they died in a common disaster. The decedents resided and perished in a state which has adopted the Uniform Simultaneous Death Act, and the property in question was located in that state. Section 3 of the Act provides that "[w]here there is no sufficient evidence that two joint tenants or tenants by the entirety have died otherwise than simultaneously the property so held shall be distributed one-half as if one had survived and one-half as if the other had survived."

Under section 2040 of the Internal Revenue Code of 1954 and section 20.2040-1(a)(2) of the Estate Tax Regulations, the decedent's gross estate includes the entire value of all jointly owned property including property held as tenants by the entirety (not acquired by the decedent and the other joint owner(s) by gift, devise, bequest, or inheritance), except the part, if any, attributable to the consideration in money or money's worth furnished by the other joint owner(s).

Section 2033 of the Code provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of death.

Rev. Rul. 66-60 holds that inasmuch as the estate of the wife is entitled to a half interest in the property, one-half of the value of the property is includible in the wife's gross estate under section 2033 of the Code.

Rev. Rul. 66-60 also holds that inasmuch as the property in question was held in tenancy by the entirety at the time of the husband's death and since there is no evidence to indicate that the wife furnished any consideration for the property, the full value of the property is includible in the husband's gross estate under section 2040 of the Code.

However, in order for any of the value of jointly held property or property held in tenancy by the entirety to be includible in a decedent's gross estate under section 2040 of the Code, the decedent must be survived by a joint tenant or a tenant by the entirety. Under the Uniform Simultaneous Death Act, the husband and wife are each considered to have survived with respect to one-half of the property. Thus, section 2040 will be applicable for determining the includibility of the value of one-half of the property in each of their gross estates. Since there is no evidence to indicate the wife furnished any consideration for the property, the value of one-half of the property with respect to which the wife is considered to have survived is includible in the husband's gross estate under section 2040. Since the husband furnished all the consideration for the property, none of the value of the one-half of the property with respect to which the husband is considered to have survived is includible in the wife's gross estate under section 2040.

In addition, since each is considered to have survived as to one-half of the property, each is considered to have acquired an absolute, sole ownership interest in one-half of the property before death. Thus, the value of one-half of the property is includible in each of their gross estates under section 2033 of the Code.

Rev. Rul. 66-60 stated that the value of one-half of the property was includible in the wife's gross estate under section 2033 of the Code because her estate was entitled to a half interest in the property. However, the mere fact that property becomes part of a decedent's estate does not make the property includible in a decedent's gross estate under section 2033. *See* Rev. Rul. 75-126, 1975-1 C.B. 296; Rev. Rul. 75-127, 1975-1 C.B. 297; and Rev. Rul. 75-145, 1975-1 C.B. 298, where the decedent had no interest in the property at death. In the instant case, the requirement of section 2033 is satisfied with respect to the one-half of the property as to which the wife is deemed to have survived and which she therefore is considered to have owned at death.

Thus, the result here is the same as in Rev. Rul. 66-60, that is, inclusion of the full value of the property in the husband's gross estate and inclusion of the value of one-half of the property in the wife's gross estate. However, the basis for inclusion in each of the gross estates is different.

Rev. Rul. 66-60 is hereby modified.

26 CFR 20.2033-1: Property in which the decedent had an interest.
(Also Section 2039; 20.2039-1.)

Gross estate; survivorship annuity; veteran. The value of an annuity payable as "Veterans' Benefits" to the surviving spouse of a deceased veteran is not includible in the veteran's gross estate under section 2033 or section 2039 of the Code.

Rev. Rul. 76-501

Advice has been requested whether the value of an annuity payable under Chapter 13 of Title 38 of the United States Code, "Veterans' Benefits," to the surviving spouse of a deceased veteran, is includible in the decedent's gross estate under either section 2033 or section 2039 of the Internal Revenue Code of 1954.

The decedent, a former member of the Armed Forces of the United States, died in 1976 from a service-connected disability. Upon the death of the decedent, the surviving spouse became entitled to a monthly benefit payment in an amount specified in the statute. The decedent made no contribution toward the purchase of the annuity that became payable to the surviving spouse.

Chapter 13 of Title 38 of the United States Code (1970), as amended, dealing with service-connected deaths, provides, in part, as follows:

SUBCHAPTER II—DEPENDENCY AND INDEMNITY COMPENSATION

* * * * *

Sec. 410. Deaths entitling survivors to dependency and indemnity compensation

(a) When any veteran dies after December 31, 1956, from a service-connected or compensable disability, the Administrator shall pay dependency and indemnity compensation to his widow, children, and parents. The standards and criteria for determining whether or not a disability is service-connected shall be those applicable under chapter 11 of this title.

* * * * *

Section 2033 of the Code provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of death.

Section 2039(a) of the Code provides for the inclusion in the decedent's gross estate of the value of an annuity or other payment receivable by any beneficiary, by reason of surviving the decedent, under any form of contract or agreement entered into after March 3, 1931, other than insurance on the decedent's life, if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such benefits for life or for any period not ascertainable without reference to the decedent's death or for any period which does not in fact end before the decedent's death.

Section 20.2039-1(b) of the Estate Tax Regulations provides that the term "contract or agreement," as used in section 2039 of the Code, includes any arrangement, understanding or plan, or any combination of these arising by reason of employment.

An examination of the pertinent provisions of Chapter 13 of Title 38 of the United States Code, as amended, shows that the decedent had no voice in the designation of the beneficiaries or the benefits payable to them. The categories of beneficiaries, the determination whether a claimant is an eligible beneficiary, and the amounts payable are controlled by the provisions of Title 38 of the United States Code, and payments are made directly to the beneficiary. Further, the benefits are payable from Government appropriations, not from any fund in which the decedent had a vested interest.

In view of the foregoing, it is concluded that the indemnity compensation payable to the decedent's surviving spouse is not property in which the decedent had an interest at the time of death within the meaning of section 2033 of the Code.

Furthermore, the benefits are not payable under any form of contract or agreement entered into by the decedent or arising by reason of the decedent's employment for the purposes of section 2039 of the Code, but under the provisions of a public law enacted to assure a system of benefit payments to the dependents of veterans whose deaths resulted from injuries suffered while in the service of their country. See Rev. Rul. 55-581, 1955-2 C.B. 381 (involving payments to beneficiaries of members of the Armed Forces who died while on active duty), Rev. Rul. 60-70, 1960-1 C.B. 372 (involving payments to survivors of a deceased railroad employee under the Railroad Retirement Act of 1937), and Rev. Rul. 76-102, 1976-1 C.B. 272 (involving payments to survivors of a deceased coal miner under the Federal Coal Mine Health and Safety Act of 1969).

Accordingly, the value of the annuity payable to the surviving spouse of the deceased veteran under Chapter 13 of Title 38 of the United States Code is not includible in the decedent's gross estate under section 2033 or section 2039 of the Code.

Section 2035.—Transactions in Contemplation of Death

26 CFR 20.2035-1: Transactions in contemplation of death.

Transfer in contemplation of death; tenants by the entirety. One-half the value of real property held by a married couple as tenants by the entirety and subsequently transferred to a third party in contemplation of the death of one of the spouses, in a state whose law provides that a tenancy by the entirety cannot be severed by either spouse acting alone and that each spouse is entitled to one-half the income from such property, is includible in the estate of the deceased spouse, even though the other spouse had purchased the property with separate funds and had elected not to report a gift at the time they took title to the property.

Rev. Rul. 76-348

In 1961, *A*, with individually owned funds, purchased a parcel of real property located in State *X*, and had it titled in the names of *A* and *B* (*A*'s spouse) as tenants by the entirety. Pursuant to section 2515(a) of the Internal Revenue Code of 1954, *A* did not elect to report a gift to *B* at the time they took title to the property as tenants by the entirety.

Under the law of State *X*, where *A* and *B* resided and where the real property was located, a tenancy by the entirety cannot be severed by either spouse acting alone, and each spouse is entitled to one-half the income from such property. In 1975, *A* and *B*, pursuant to an estate planning arrangement, gratuitously transferred the real property to their children. For Federal gift tax purposes, the transfer was reported as wholly a gift by *A*. Nine months after the transfer, *B* died of incurable cancer.

Following *United States v. Heasty,* 370 F. 2d 525 (10th Cir. 1966), which decided that the interest of joint tenants in real property must be determined according to local property law and not by a Federal estate tax concept of transfer, Rev. Rul. 69-577, 1969-2 C.B. 173, holds that if under applicable local law each spouse is entitled to one-half the income from property held in tenancy by the entirety, the cotenants' interest in the property is essentially the same as that in a joint tenancy. Under such circumstances, that Revenue Ruling holds that one-half the value of trust property is includible in each cotenant's gross estate under section 2036(a)(1) of the Code (dealing with transfers with retained life estate) if tenancy by the entirety property is transferred in trust to pay one-half the income therefrom to each spouse during their joint lives and the entire income to the survivor for life, and the remainder to a third person. In *Sullivan's Estate v. Commissioner,* 175 F. 2d 657 (9th Cir. 1949), the court, in reversing the Tax Court, held that only one-half the value of property held in joint tenancies, which had been terminated in contemplation of death within the meaning of section 811 of the Internal Revenue Code of 1939 (predecessor of section 2035 of the 1954 Code), was includible in the decedent's gross estate even though the decedent furnished the entire consideration for the properties. *Accord, Edward Carnall,* 25 T.C. 654 (1955), *acq.* 1969-2 C.B. xxiv; *A. Carl Borner,* 25 T.C. 584 (1955), *acq.* 1969-2 C.B. xxiii; and *Don M. Brockway,* 18 T.C. 488 (1952), *acq.* 1969-2 C.B. xxiv.

Held, since, under the law of State *X*, *A* and *B* are each deemed to have acquired a half interest in the property at the time the tenancy by the entirety was created, one-half the value of the property transferred within three years of *B*'s death, in furtherance of an estate planning arrangement, is includible in *B*'s gross estate under section 2035 of the Code, notwithstanding the Federal gift tax election made by *A* to not report a gift to *B* at the time they initially took title to the property as tenants by the entirety.

Section 2036.—Transfers with Retained Life Estate

26 CFR 20.2036-1: Transfers with retained life estate.

Charitable remainder unitrust; valuation. The entire value of the corpus of an inter vivos charitable remainder unitrust from which the grantor retained a life payment of a unitrust adjusted payout rate of 5.660 percent or greater is includible in the decedent's gross estate. The method is provided to compute the proportion of the trust assets includible in the gross estate for a unitrust adjusted payout rate less than 5.660 percent.

Rev. Rul. 76-273

Advice has been requested whether the value of the corpus of an inter vivos charitable remainder unitrust is includible under section 2036 of the Internal Revenue Code of 1954 in the circumstances described below; and if so, the proper method of determining the includible portion.

In November 1969, *A* created a charitable remainder trust, naming *M* trust company as trustee. The provisions of the trust instrument met all the requirements of a charitable remainder unitrust as described in section 664 of the Code. The trust instrument directed the trustee to hold, invest, and reinvest the corpus of the trust and pay quarterly to *A*, for life, an amount equal to 6 percent of the fair market value of the trust as valued on the first day of each taxable year of the trust. Based on section 1.664-4(b)(2) of the Income Tax Regulations, the appropriate adjusted payout rate for the unitrust was 5.871 percent. At the termination of the trust, the then corpus, together with any and all the accrued income, was to be distributed to a charitable organization. *A* died in May 1975.

Section 2036 of the Code provides:

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, * * *

Section 20.2036-1(a) of the Estate Tax Regulations provides:

If the decedent retained or reserved an interest or right with respect to all of the property transferred by him, the amount to be included in his gross estate under section 2036 is the value of the entire property, less only the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death.

Under the Code and regulations,

the includibility in the gross estate of the assets of a trust in which the deceased grantor has retained a lifetime income interest is predicated upon three requirements: (1) there must be an inter vivos transfer by the decedent in trust or otherwise; (2) decedent must have retained the possession or enjoyment of, or the right to income from, the property; (3) such retention or reservation must have been for decedent's life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death. *Richards v. Commissioner,* 375 F. 2d 997 (10th Cir 1967); *Kasishke v. United States,* 426 F. 2d 429 (10th Cir. 1970).

The language of section 2036 of the Code is very broad and its application extends to all property to the extent of any interest therein transferred by the decedent.

Under section 2031 of the Code and section 20.2031-10 of the regulations, an interest rate of six percent per annum is used for valuation purposes with respect to decedents dying after December 31, 1970. See also section 1.664-4(a)(1)(ii) of the Income Tax Regulations. Here, strictly speaking, *A* did not retain the right to the income from the property transferred, but retained instead the right to receive the unitrust amount.

The life beneficiary of a unitrust having an adjusted payout rate of 5.660 percent receives, in effect, the entire income from the trust assets where those assets are assumed to produce a six percent return on investment. The rate of 5.660 percent results from the following formula:

$$\text{Equivalent income interest rate} = \frac{\text{Unitrust adjusted payout rate}}{\text{1 minus adjusted payout rate}}$$

In the present case, the interest retained by *A* had an adjusted payout rate of 5.871 percent. It thus exceeded the payout rate (5.660%) that is equivalent to a full income interest in the trust assets. Therefore, *A* effectively retained the income from all the assets transferred to the unitrust. Cf. *Smith v. Westover,* 89 F. Supp. 432 (S.D. Cal. 1950), *aff'd per curiam,* 191 F. 2d 1003 (9th Cir. 1951).

A has retained an amount which is a charge against the whole corpus and which is payable in all events, regardless of available income. The tax consequences of a transaction depend on the substance of the transaction rather than its form. *Helvering v. Clifford,* 309 U.S. 331 (1940); *Spiegel's Estate v. Commissioner,* 335 U.S. 701 (1949).

Accordingly, since *A* retained for life an interest at least equal to the right to the income from all the property transferred by *A* to the charitable remainder unitrust, the entire value of the property in such trust is includible in *A*'s gross estate under section 2036(a)(1) of the Code. If *A* had retained the right to a unitrust amount having an adjusted payout rate of less than 5.660 percent, then a correspondingly reduced proportion of the trust assets would be includible in the gross estate under section 2036(a)(1). The includible portion would be determined by using the above formula to obtain the equivalent income interest rate for the trust, and then dividing that equivalent rate by six percent. Thus, the decedent's interest or share in the income rights would have to reflect the proportionate value of the property interest to which the income rights relate. *Uhl v. Commissioner,* 241 F. 2d 867 (7th Cir. 1957); *U.S. National Bank of Portland v. United States,* 188 F. Supp. 332 (D. Ore. 1960); and *Estate of Marvin L. Pardee,* 49 T.C. 140, 149-50 (1967).

Section 2038.—Revocable Transfers

26 CFR 20.2038-1: Revocable transfers.

Gross estate; death benefit under employment contract. The death benefit provision of an employment contract providing if death occurred during the term of the contract the employer would pay the benefit to the decedent's designated beneficiary, which the decedent could change during the course of employment, satisfies the transfer requirement of section 2038(a)(1) of the Code and the amount of the death benefit will be includible in the decedent's gross estate.

Rev. Rul. 76-304

Advice has been requested whether a payment made to a decedent's surviving spouse by the decedent's employer is includible in the decedent's gross estate under section 2038(a)(1) of the Internal Revenue Code of 1954, under the circumstances described below.

On January 1, 1975, the decedent and *X* Corporation entered into an employment contract whereby, in consideration of the decedent's performance of services, the corporation agreed to pay decedent a stated yearly salary and also agreed to pay a death benefit of a stated amount to decedent's designated beneficiary if decedent was employed by the corporation at date of death. Under the terms of the agreement decedent could change the beneficiary of the payment during the course of employment with the corporation.

Upon decedent's death on September 12, 1975, while employed by the corporation the death benefit was paid to the decedent's surviving spouse.

The issue presented is whether the transfer requirement of section 2038(a)(1) of the Code is satisfied where a decedent-employee procured the transfer by such decedent's employer of a death benefit to the decedent's surviving spouse in return for the performance of services during the course of employment.

Section 2038(a)(1) of the Code provides that the value of the gross

estate shall include the value of all property transferred by the decedent, in trust or otherwise, the enjoyment of which at the date of death is subject to any change through the exercise of a power, either alone or in conjunction with another person, to alter, amend, revoke or terminate the enjoyment of the beneficial interest in the property. Section 2038 does not apply to property interests that the decedent did not own and thus did not transfer.

If a decedent furnishes consideration for a transfer nominally made by another, the decedent will be in substance considered the actual transferor. *Lehman v. Commissioner*, 109 F. 2d 99 (2nd Cir. 1940). Upon decedent's death, the transferred property is includible in the decedent's gross estate if the decedent possesses at death an interest or power which, under the transfer sections of the Code, provides a basis for imposing the estate tax.

In *Estate of Fried v. Commissioner*, 445 F. 2d 979 (2nd Cir. 1971), *aff'g* 54 T.C. 805 (1970), *cert. denied*, 404 U.S. 1016 (1972), a decedent's transfer of such decedent's interest in partnership assets to a newly formed corporation was held to be consideration for the corporate-employer's transfer of stock of equivalent value to the decedent, and such employer's promise to pay disability and death benefits. In *William L. Nevin*, 11 T.C. 59 (1948), *acq.*, 1949-1 C.B. 3, the decedent's promise to retire from a position with the corporate-employer from which decedent could not have been forced to retire was held to be consideration for the employer's promise to pay a sum certain over a term of years to decedent or decedent's surviving spouse.

Under the terms of the agreement executed in the instant case, the corporation was to pay a death benefit to the decedent's surviving spouse upon the decedent's death while still employed by the corporation. The corporation's promise to pay the death benefit was given in consideration of the decedent's promise to render future services, which the decedent discharged on a day-to-day basis during the course of decedent's employment career with *X* Corporation.

In *Estate of Bogley v. United States*, 514 F. 2d 1027 (Ct. Cl. 1975), the decedent entered into an enforceable contract with decedent's employer. Under this contract, the employer promised to pay decedent's spouse or decedent's estate two years' salary after death, in consideration for the decedent's past and future services. The court found that by making the contract with the employer, the decedent made a transfer of decedent's interest to decedent's spouse during decedent's lifetime.

Accordingly, the transfer requirement of section 2038(a)(1) of the Code is satisfied where the decedent procured the transfer by the decedent's employer of a death benefit to the decedent's surviving spouse in return for the performance of services during the course of employment. The amount of the death benefit will be includible in the decedent's gross estate, under section 2038(a)(1) of the Code, inasmuch as the decedent at date of death possessed the power to alter the designated beneficiary of the death benefit.

Section 2039.—Annuities

26 CFR 20.2039-1: Annuities.

Survivorship annuity. Benefits accruing under a qualified employee's retirement plan cannot be considered together with the benefits accruing under a nonqualified survivor's income benefit plan for purposes of determining the includibility of the value of the survivor's benefits in a decedent's gross estate under section 2039 of the Code.

Rev. Rul. 76-380

Advice has been requested whether benefits accruing under a qualified employee's retirement plan can be considered together with the benefits accruing under a nonqualified survivor's income plan for purposes of determining the includibility of the value of the survivor's benefits in the decedent's gross estate under section 2039 of the Internal Revenue Code of 1954.

The decedent died while employed by the *R* corporation. Upon decedent's death, the decedent's surviving spouse became entitled to receive 1*x* dollars per month for five years or until death or remarriage.

R corporation has two employee benefit plans: the Retirement Plan that is qualified under section 401(a) of the Code, and the Survivors Income Benefit Plan that is not qualified.

The Retirement Plan provides a monthly annuity for the employee upon retirement. The Survivors Income Benefit Plan covers all regular employees and a monthly annuity is payable in the event of an employee's death to eligible beneficiaries determined under the plan. The total amount of the benefit and the method of payment are stipulated in the plan and cannot be changed by the employee. If no eligible beneficiary survives the employee, no benefit is payable. Both plans are noncontributory.

A decedent's gross estate includes under section 2039(a) and (b) of the Code the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under certain agreements or plans to the extent that the value of the annuity or other payment is attributable to contributions made by the decedent or the decedent's employer. However, for the value of the benefits receivable by a beneficiary under a contract or agreement to be included in the decedent's gross estate, there must have been payable to the decedent under the same contract or

agreement an annuity or other payment or the decedent must have possessed the right to receive the annuity or payment, either alone or in conjunction with another, for life or for any period not ascertainable without reference to the decedent's death or for any period which does not end in fact before death.

Section 20.2039-1(b) of the Estate Tax Regulations, with respect to plans to which section 2039(a) and (b) applies, states that the term "contract or agreement" includes any arrangement, understanding, or plan, or any combination of arrangements, understandings or plans arising by reason of the decedent's employment. Section 20.2039-1(b), Example (6) states that all rights and benefits accruing to an employee and to others by reason of the employment (except rights and benefits accruing under certain plans meeting the requirements of section 401(a) (qualified plans)) are considered together in determining whether or not section 2039(a) and (b) applies.

The meaning of the statement in Example (6) of section 20.2039-1(b) of the regulations is that rights and benefits accruing under plans meeting the requirements of section 401(a) of the Code are not to be considered together with rights and benefits accruing under plans not meeting the requirements of section 401(a). See *Estate of Harold S. Brooks,* 50 T.C. 585 (1968), *acq.,* 1969-1 C.B. 20.

In view of the foregoing, the two plans under which decedent in the instant case had accrued rights and benefits cannot be read together as a single contract or agreement, thereby satisfying all the requirements of section 2039(a) of the Code. Accordingly, the value of the survivor's benefits is not includible in the decedent's gross estate.

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26 CFR 20.2039-1: Annuities.

Annuity payable to the surviving spouse of a deceased veteran under Chapter 13, Title 38, United States Code. See Rev. Rul. 76-501, page 267.

Section 2040.—Joint Interests

26 CFR 20.2040-1: Joint interests.

Husband's interest in property held in tenancy by the entirety in a simultaneous death situation. See Rev. Rul. 76-303, page 266.

Section 2041.—Powers of Appointment

26 CFR 20.2041-1: Powers of appointment; in general.

Power of appointment; trustee's invasion of principal for benefit of beneficiary. An independent trustee's power to invade trust principal for the benefit of an income beneficiary in the trustee's sole and unfettered discretion, with directions to liberally exercise its discretionary power of invasion, will not be considered a general power of appointment taxable to the decedent-income beneficiary's estate under section 2041 of the Code.

Rev. Rul. 76-368

Advice has been requested whether, under section 2041 of the Internal Revenue Code of 1954, a power of invasion not limited by an ascertainable standard, granted to an independent trustee, can be imputed to the decedent-income beneficiary of a trust under the circumstances described below.

The decedent's spouse, who died testate in 1965, created a testamentary trust under the terms of which the trust income was payable to the decedent for life, and the remainder payable to other named persons upon the decedent's death. The trustee, an independent bank, was authorized to invade the trust corpus and pay portions thereof to or for the use and benefit of the decedent in such manner as the trustee, *in its sole and unfettered discretion,* deemed advisable should the decedent be in need of funds in excess of the trust income for "health, comfort, maintenance, welfare, or for any other purpose or purposes." The trustee was directed to liberally exercise its discretionary power of invasion. Prior to the decedent's death in 1976, numerous requests had been made to the trustee for additional funds and all such requests of the decedent had been honored by the trustee.

Section 2041(a)(2) of the Code provides that the value of the gross estate shall include the value of all property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942. For Federal estate tax purposes, section 2041(b) defines a "general power of appointment," subject to certain specific exceptions not here relevant, as a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate.

Under section 20.2041-1(b) of the Estate Tax Regulations, defining a power of appointment, it is provided that a power to consume or appropriate property is a power of appointment if, for example, a trust instrument provides that the beneficiary may appropriate or consume the principal of a trust.

While legal rights and interests in property (such as the creation and the breadth of a power to appropriate or consume the principal of a trust) is a matter of state law, it is the Federal law that designates what rights or interests so created shall be taxed. *United States v. Pelzer,* 312 U.S. 399 (1941), 1941-1 C.B. 441; *Morgan v. Commissioner,* 309 U.S. 78 (1940), 1940-1 C.B. 229. Thus, in determining whether an independent trustee's broad power of invasion can be imputed to a decedent-income beneficiary, the initial step is to ascertain the scope of the decedent's rights under the applicable state law. *Peoples Trust Company of Bergen County v. U.S.,* 412 F.2d 1156 (3rd Cir. 1969).

In *Ewing v. Roundtree,* 346 F.2d 471 (6th Cir. 1965), the decedent was the income beneficiary of a testamentary trust established by decedent's

predeceased spouse under Tennessee law. The trustee was authorized and directed, *should the decedent request it,* to sell each year certain stocks out of the trust corpus and pay the proceeds of the sale(s) to the decedent. Under the language of the spouse's will, the court found that, in the sole discretion of the decedent, the decedent could have required the trustee to sell the stocks and pay the proceeds to the decedent. The decedent's power to compel such action by the trustee was not limited by the terms of the will. Therefore, the court held that the decedent possessed a general power of appointment under section 2041 of the Code.

In *Peoples Trust Company of Bergen County v. U.S.,* cited above, the decedent was the income beneficiary of a testamentary trust established by decedent's predeceased spouse under New Jersey law. The trustee was directed to pay to the decedent such amounts out of the principal as the decedent from time to time might require, *with the decedent being the sole judge as to the amounts and frequency of such principal payments.* Based on the language of the spouse's will, the court held that the decedent possessed a general power of appointment under section 2041 of the Code inasmuch as the decedent was the sole judge of the extent and timing of any invasions of trust principal. Under the law of New Jersey, the decedent's power was found to be completely unfettered as to its breadth.

In the *Estate of Janice McNear Towle,* 54 T.C. 368 (1970), the decedent was the income beneficiary of three post-October 21, 1942, settlement contracts of insurance on the life of the decedent's then deceased parent. Under the settlement contract, the decedent had two rights, one of which was the privilege of withdrawing at any time all of the retained principal with the consent of a bank in its capacity as trustee under the deceased parent's will. The court held that the trustee's consent was not limited by a substantial adverse interest in the property within the meaning of section 2041 (b)(1)(C)(ii) of the Code; consequently, the insurance proceeds were includible in the decedent's gross estate under section 2041(a).

Under the above cases, if a power of invasion is expressly granted to the deceased-income beneficiary, the property subject to such power should be included in the decedent's gross estate. On the other hand, in the absence of an express grant of a general power of appointment, whether a nontrustee beneficiary has such power must be gleaned from all the provisions of the governing instrument and any extrinsic evidence that may bear on the issue.

For example, in the *Estate of Mary Joyce Cox,* 59 T.C. 825 (1973), *acq.,* 1973-2 C.B. 1, the court held that, under Texas law, the income beneficiary did not hold a power of invasion or appointment with respect to a testamentary trust that provided the trustee (the testator's son) was to have the "sole and exclusive right of management" of the trust property, and that if the income was insufficient to comfortably and adequately supply the beneficiary with all comfort and necessities, then the beneficiary's comfort and necessities were to be provided for by the trustee selling trust assets. In reaching its decision that the trustee and not the beneficiary had the power of appointment or invasion, the court determined that neither the words of the will nor the extrinsic evidence indicated an intent by the testator to grant such a power to the income beneficiary. It thus decided that to attribute to the beneficiary an implied power of invasion would be inconsistent with the testator's intent and with the will provision expressly granting the trustee "sole and exclusive" management powers.

In *Security-Peoples Trust Co. v. U.S.,* 238 F. Supp. 40 (W.D. Pa. 1965), the testamentary trustee, an independent bank, was authorized "* * * to advance portions of the principal of the Trust Estate to or for the use or benefit of [the decedent-income beneficiary and others], in such amounts, and for such purposes as my Trustee in its discretion may deem advisable. I direct that my Trustee shall exercise liberally the power to advance principal herein conferred to promote the health, comfort, maintenance or welfare of the income beneficiaries hereinabove referred to. * * *"

The decedent was not a trustee of the above trust and was given no power regarding the invasion of principal by the independent trustee. Decedent's interest terminated at decedent's death, and the remainder was bequeathed for the benefit of certain named beneficiaries. The Government, applying the rule in *Helvering v. Clifford,* 309 U.S. 331, 334 (1940), 1940-1 C.B. 105, that "Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue," argued basically that, under Pennsylvania law, a beneficiary can compel the trustee to exercise its discretion to use trust property for the benefit of the beneficiary. The court held against the Government, stating that in the absence of a showing of necessity, and clear direction in the instrument, Pennsylvania courts will not compel the trustee's exercise of discretion, and will support the trustee's discretion to refuse or withhold invasions of principal. *Seacrist Estate,* 362 Pa. 190, 66 A. 2d 836 (1949). The presence of additional life beneficiaries and remaindermen required the trustee to protect their interests against invasions for decedent so as to not defeat the testator's intention.

In the instant case, as in *Estate of Mary Joyce Cox* and *Security-Peoples Trust Co.,* the independent trustee alone was expressly authorized to invade the trust corpus and pay portions thereof to or for the use and benefit of the decedent as the trustee, in its sole

and unfettered discretion, deemed advisable for the stated purposes. The governing trust instrument did not give the decedent any supervening right or power, or even a conjunctive right or power, such as would indicate an intent by the testator to grant to the decedent the power to consume or appropriate the trust principal.

While the decedent had the power to invoke a process of judicial review had the trustee, in the judgment of the decedent, failed to liberally exercise its discretionary power of invasion on the decedent's behalf, this kind of power does not transfer a power of invasion granted an independent trustee to the beneficiary of the trust.

Accordingly, the power of invasion not limited by an ascertainable standard, granted to the independent trustee, cannot be imputed to the decedent so as to render the power taxable in the decedent's gross estate under section 2041 of the Code.

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26 CFR 20.2041-1: Powers of appointment; in general.
(Also Section 2056; 20.2056(b)-5.)

Marital deduction; life estate with power of appointment; Maryland. A testamentary trust providing that a decedent's spouse will receive the income of a trust for life and may appoint the corpus by will is not a general power of appointment under Maryland law, and the value of the trust corpus is neither allowed to the decedent's estate as a marital deduction under section 2056 of the Code nor includible in the spouse's gross estate under section 2041.

Rev. Rul. 76-502

Advice has been requested regarding the Federal estate tax consequences of the testamentary clause described below under sections 2041 and 2056 of the Internal Revenue Code of 1954.

A, a lifelong resident of the State of Maryland, died testate in 1976 and created a testamentry trust under the terms of which the trust income was payable to *B* (*A*'s spouse) for life. *B* was given the following power over the corpus of *A*'s trust:

> Upon the death of my spouse, *B*, the corpus of the trust estate shall be paid over in such portions as my spouse, *B*, may by Last Will and Testament designate and appoint. In the event my spouse, *B*, fails to exercise effectively such power of appointment, then the corpus shall be paid over to my children, *C* and *D*, share and share alike.

Five months after *A*'s death *B* died and, by will, *B* effectively exercised the power of appointment conferred by *A*'s will in favor of seven named individuals other than *C* and *D*.

The two questions presented are (1) whether *A*'s estate is entitled to a marital deduction under section 2056 of the Code, and (2) whether the corpus of the trust is includible in *B*'s gross estate under section 2041.

Section 2041(a)(2) of the Code provides that the value of the gross estate shall include the value of all property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942. For Federal estate tax purposes, section 2041 (b) defines a "general power of appointment," subject to certain specific exceptions not here relevant, as a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate.

Section 2056(a) of the Code provides for a marital deduction with respect to property passing to a decedent's surviving spouse. Section 2056(b)(1) contains, however, a general rule that certain terminable interests as defined in that section that pass to a surviving spouse cannot qualify for the marital deduction. Under certain exceptions to the terminable interest rule, a marital deduction may nevertheless be allowable with respect to a terminable interest passing to a surviving spouse. One of those exceptions is set forth in section 2056(b)(5) as follows:

> LIFE ESTATE WITH POWER OF APPOINTMENT IN SURVIVING SPOUSE.—In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse—
>
> (A) the interest or such portion thereof so passing shall, for purposes of subsection (a), be considered as passing to the surviving spouse, and
>
> (B) no part of the interest so passing shall, for purposes of paragraph (1)(A), be considered as passing to any person other than the surviving spouse.
>
> This paragraph shall apply only if such power in the surviving spouse to appoint the entire interest, or such specific portion thereof, whether exercisable by will or during life, is exercisable by such spouse alone and in all events.

Section 20.2056(b)-5(g) of the Estate Tax Regulations contains the following provisions with respect to the power of appointment required by section 2056(b)(5) of the Code:

> *Power of appointment in surviving spouse.*
>
> (1) * * *.
>
> (2) The power of the surviving spouse must be a power to appoint the entire interest or a specific portion of it as unqualified owner (and free of the trust if a trust is involved, or free of the joint tenancy if a joint tenancy is involved) or to appoint the entire interest or a specific portion of it as a part of her estate (and free of the trust if a trust is involved), that is, in effect, to dispose of it to whomsoever she pleases. * * *. An interest passing in trust will not be regarded as failing to satisfy the condition merely because takers in default of the surviving spouse's exercise of the power are designated by the decedent. The decedent may provide that, in default of exercise of the power, the trust shall continue for an additional period.
>
> (3) * * *.
>
> (4) The power in the surviving spouse is exercisable in all events only if it exists immediately following the decedent's death. For example, if the power given to the

surviving spouse is exercisable during life, but cannot be effectively exercised before distribution of the assets by the executor, the power is not exercisable in all events. Similarly, if the power is exercisable by will, but cannot be effectively exercised in the event the surviving spouse dies before distribution of the assets by the executor, the power is not exercisable in all events. However, an interest will not be disqualified by the mere fact that, in the event the power is exercised during administration of the estate, distribution of the property to the appointee will be delayed for the period of administration. If the power is in existence at all times following the decedent's death, limitations of a formal nature will not disqualify an interest. Examples of formal limitations on a power exercisable during life are requirements that an exercise must be in a particular form, that it must be filed with a trustee during the spouse's life, that reasonable notice must be given, or that reasonable intervals must elapse between successive partial exercises. Examples of formal limitations on a power exercisable by will are that it must be exercised by a will executed by the surviving spouse after the decedent's death or that exercise must be by specific reference to the power.

With respect to the qualification of a life estate with power of appointment trust for the marital deduction, section 20.2056(b)-5(e) of the regulations provides that "regard is to be had to the applicable provisions of the law of the jurisdiction under which the interest passes and, if the interest is in trust, the applicable provisions of the law governing the administration of the trust."

While it is the Federal law that designates what rights or interests shall be taxed after they are created, the creation of legal rights and interests in property (such as the breadth and scope of a power of appointment over the corpus of a testamentary trust) is a matter of state law. *United States v. Pelzer,* 312 U.S. 399 (1941), 1941-1 C.B. 441; *Morgan v. Commissioner,* 309 U.S. 78 (1940), 1940-1 C.B. 229. Thus, since Maryland law govern the nature of the power given to *B* in *A*'s trust, it is necessary to look to Maryland law to determine whether *B* could have appointed the corpus of the trust to *B*'s estate, *B*'s creditors, of the creditors of *B*'s estate.

In *Connor v. O'Hara,* 188 Md. 527, 53 A. 2d 33 (1947), the testatrix left her estate in trust to her legally adopted son, with remainder to such persons as he might appoint by will. At page 34 of its opinion, the Maryland Court of Appeals stated:

* * * Decisions or dicta of this court indicate that a donee has no power (unless expressly conferred) to appoint for payment of his own debts. Balls v. Dampman, 69 Md. 390, 16 A. 16, 1 L.R.A. 545; Price v. Cherbonnier, 103 Md. 107, 110, 111, 63 A. 209; cf. Wyeth v. Safe Deposit & Trust Co., 176 Md. 369, 376, 4 A.2d 753; appointed property is not part of the donee's estate, not subject to the jurisdiction of the Orphans' Court, and not subject to payment of the donee's debts. Prince de Bearn v. Winans, 111 Md. 434, 472, 74 A. 626. In O'Hara v. O'Hara, 185 Md. 321, 44 A.2d 813, 816, 163 A.L.R. 1444, it was held, with respect to this will of Sarah E. O'Hara, that the donee of the testamentary power could not during his life bind himself by contract as to the exercise of the power, and that "the subject-matter of the power" was not his property, but "the property of his mother".

In *Leser v. Burnet,* 46 F. 2d 756 (4th Cir. 1931), the decedent was the donee of a power created by a testator that gave the decedent the right to appoint certain property to such persons as the decedent named in decedent's will. The court was faced with the question of whether the decedent's exercise of this power was taxable under section 402(e) of the Revenue Act of 1921, the predecessor of section 2041 of the 1954 Code. After analyzing the Maryland cases, the court stated:

In the light of these authorities, we would not be justified in holding otherwise than that, under the law of Maryland, language such as that used in Fulton's conveyance, which would ordinarily create a general power with right in the donee to appoint for the benefit of his own creditors, does not have such effect in Maryland, but created a naked power from which neither the estate of the donee nor his creditors can possibly benefit. This does not mean that a general power cannot be created in Maryland. It means merely that language such as this, sufficient to create a general power elsewhere, creates merely a special power in Maryland for the reason that under the Maryland law the donee under such a power cannot exercise same in the interest of himself or his creditors. A general power could doubtless be created in Maryland by expressing in the language creating it what is held to be implied in most other jurisdictions, viz., that the donee may exercise same for his own benefit or for the benefit of his creditors; but unless this is expressed, the power under the Maryland decisions is not general, but limited; and being limited, it does not come within the meaning of a general power of appointment as that term is used in the language of the revenue act.

In *Estate of Marvin G. Pierpont,* 21 CCH Tax Ct. Mem. 1515 (1962), *aff'd* 336 F. 2d 277 (4th Cir. 1964), *cert. denied,* 380 U.S. 908 (1965), a question arose as to whether a power of appointment under Maryland law met the requirements for the marital deduction. In *Pierpont,* the spouse was given a power to appoint the corpus of a trust in such manner and proportions as she might appoint by her will.

In denying the marital deduction, the Tax Court observed: "* * * But the scope of Lallah's [the spouse] power of appointment is to be determined under the law of Maryland, and, as this Court has recognized in *Estate of William C. Allen,* * * * 29 T.C. 465 (1957), the donee of an otherwise general power of appointment does not, under Maryland law, have the right to appoint the property subject to the power to his estate or for the payment of his debts, *absent language expressly conferring such right in the instrument by which the power of appointment is granted.*" (Emphasis added.)

In the instant case, *A* did not give *B* the express power to appoint the corpus of *A*'s trust to either *B*, *B*'s estate, *B*'s creditors, or the creditors of *B*'s estate. The law of Maryland did not allow *B* to exercise the power in such a fashion in the absence of an express grant. Therefore, *B*'s power of appointment did not meet the requirements of either section 2041(b) or section 2056(b)(5) of the Code as to the permissible appointees under the power. Accordingly, *A*'s estate is not entitled to a marital deduction under section 2056 with respect to *B*'s interest in the trust. Furthermore,

the value of the corpus of the trust is not includible in the value of *B*'s gross estate under section 2041.

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26 CFR 20.2041-3: Powers of appointment created after October 21, 1942.

General power of appointment; conjunctive control of trust. One third of the value of a trust created by three siblings, each of whom named an adult child as one of three trustees who together had complete discretionary power over the assets of the trust and individually had the right to name a relative as successor, is includible in a decedent-trustee's estate as property subject to a general power of appointment under section 2041 of the Code.

Rev. Rul. 76-503

Advice has been requested as to the amount includible in a decedent's gross estate as the value of property subject to a general power of appointment, under section 2041 of the Internal Revenue Code of 1954, in the circumstances described below.

In 1973, three siblings named *A*, *B*, and *C* owned equal interests in their family business. They decided to place the business in trust for the benefit of their descendants and with a view toward keeping the family enterprise intact. Each sibling-grantor designated one of the sibling's adult children as one of the three trustees of the trust. Under the terms of the trust, income is to be accumulated and added to principal until the trust terminates. The trust shall terminate exactly twenty years after the death of the last surviving descendant of *A*, *B*, and *C* who is living at the date of creation of the trust.

The trustees are empowered to manage the trust assets in their complete discretion. They are also empowered to distribute trust property to whomever they select, including themselves, in such proportions, at such times, and for such purposes as they see fit. Each trustee is privileged to designate one of the trustee's relatives to serve as a successor trustee in the event of the trustee's death or resignation. In the absence of such a designation, the oldest adult living descendant of the deceased or resigned trustee who is willing to serve as the new trustee shall occupy the vacant trustee position.

The decedent, *D*, was selected by *A* to be one of the three trustees and *D* continued in that position until *D*'s death in 1975.

The question presented is whether any amount is includible, with respect to the trust described above, in *D*'s gross estate under section 2041 of the Code as the value of property subject to a general power of appointment, in view of the fact that the power was held jointly by *D* and two cotrustees.

Section 2041(a)(2) of the Code requires inclusion in the gross estate of the value of all property with respect to which the decedent has, at the time of death, a "general power of appointment" created after October 21, 1942.

Section 2041(b) of the Code provides, in relevant part, the definition of the term "general power of appointment" as follows:

> (b) DEFINITIONS.—For purposes of subsection (a)—
> (1) GENERAL POWER OF APPOINTMENT.—The term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that—
> (A) * * *
> (B) * * *
> (C) In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person—
> (i) If the power is not exercisable by the decedent except in conjunction with the creator of the power—such power shall not be deemed a general power of appointment.
> (ii) If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent—such power shall not be deemed a general power of appointment. For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the decedent's power.
> (iii) If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person—such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the decedent) in favor of whom such power is exercisable.
>
> For purposes of clauses (ii) and (iii), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.

Section 20.2041-3(c) of the Estate Tax Regulations provides the following with respect to jointly held powers of appointment created after October 21, 1942:

* * * * *

> (2) Such power is not considered a general power of appointment if it is not exercisable by the decedent except with the consent or joinder of a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate. An interest adverse to the exercise of a power is considered as substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, the interest is to be valued in accordance with the actuarial principles set forth in § 20.2031-7 or, if it is not susceptible to valuation under those provisions, in accordance with the general principles set forth in § 20.2031-1. A taker in default of appointment under a power has an interest which is adverse to an exercise of the power. A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the decedent's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the

exercise of the power in favor of X. Similarly, if on Y's death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y. * * *

(3) A power which is exercisable only in conjunction with another person, and which after application of the rules set forth in subparagraphs (1) and (2) of this paragraph constitutes a general power of appointment, will be treated as though the holders of the power who are permissible appointees of the property were joint owners of property subject to the power. The decedent, under this rule, will be treated as possessed of a general power of appointment over an aliquot share of the property to be determined with reference to the number of joint holders, including the decedent, who (or whose estates or creditors) are permissible appointees. Thus, for example, if X, Y, and Z hold an unlimited power jointly to appoint among a group of persons, including themselves, but on the death of X the power does not pass to Y and Z jointly, then Y and Z are not considered to have interests adverse to the exercise of the power in favor of X. In this case X is considered to possess a general power of appointment as to one-third of the property subject to the power.

In the above-quoted portion of section 20.2041-3(c)(2) of the regulations, the example provided describes *Y* and *Z* as having substantial interests, in the property subject to the jointly held power of appointment, that are adverse to exercise of the power in favor of the decedent *X* because the power will pass to *Y* and *Z* upon the death of *X*. In such a situation, *Y* and *Z* will be able to exercise, by themselves, the power in their own favor after the death of *X*, so it is in their economic interest to refuse to agree to exercise the power in favor of *X* during *X*'s lifetime. Their ability to benefit themselves is thus enlarged by the death of *X*. In such circumstances, the Code and regulations (quoted above) provide that the potential survivors of the decedent hold an interest and that it is adverse to the exercise of the power in favor of the decedent.

Where, however, as in the example in section 20.2041-3(c)(3) of the regulations, the surviving coholders of the power do not receive, at the death of the decedent, the entire power of appointment between themselves but must continue to share the power with the decedent's replacement, they would not necessarily be in a better economic position after the decedent's death than they are before the death. In such a situation, the fact that the coholders may survive the decedent does not mean that they stand to profit by refusing to exercise the power in favor of the decedent during the decedent's lifetime. Therefore, the coholders of the power do not have an interest that is adverse to exercise of the power in favor of the decedent for purposes of section 2041(b)(1)(c)(ii) of the Code.

If the coholders of the power, who must share their power with the decedent's replacement upon the death or resignation of the decedent, have no interest in the subject property other than as coholders of, and permissible appointees under, the power, those facts alone cannot support the conclusion that they hold adverse interests. As a result, the decedent's power meets the definition of a "general power of appointment" because the coholders of the power in actuality have no substantial interest in the subject property, which is adverse to the exercise of the power in favor of the decedent.

If the coholders of the decedent's general power of appointment are, along with the decedent, permissible appointees of the subject property, the amount includible in the decedent's gross estate is the value of the subject property divided by the total number of holders of the power who are also permissible appointees, pursuant to section 2041(b)(1)(C)(iii) of the Code and section 20.2041-3(c)(3) of the regulations, quoted above.

Accordingly, in the instant case, one third of the value of the trust (as of the date of death of *D* or appropriate alternate valuation date) is includible in the gross estate of *D* under section 2041 of the Code as property subject to a general power of appointment.

Section 2042.—Proceeds of Life Insurance

26 CFR 20.2042-1: Proceeds of life insurance.

Life insurance policy in trust; incidents of ownership. A decedent who had purchased a life insurance policy on his life, transferred complete ownership to his wife, and upon her death, as trustee of a residuary trust for the benefit of their children that included the policy, could use the loan value to pay premiums, elect to receive annual dividends, borrow on the policy and assign or pledge it, and determine how the proceeds were paid, possessed sufficient incidents of ownership to require inclusion of the policy proceeds in his estate.

Rev. Rul. 76-261

Advice has been requested whether, under the circumstances described below, the insured-decedent possessed sufficient incidents of ownership in an insurance policy held in a fiduciary capacity to require inclusion of the policy proceeds in the gross estate under section 2042 of the Internal Revenue Code of 1954.

In 1957 the decedent, *H*, purchased an insurance policy on decedent's life. Decedent's spouse, *W*, was named beneficiary. In 1962 *H* transferred complete ownership of the policy to *W* and added the names of their children as beneficiaries. In 1971 *W* died. In *W*'s will, *H* was named executor of *W*'s estate and trustee of a residuary trust established for the benefit of their children. The insurance policy on *H*'s life was included in *W*'s residuary estate.

H, as trustee, was granted absolute and unfettered discretion to distribute the current income from the trust to the beneficiaries or accumulate the income and add it to corpus. In addition, *H*, as trustee, was empowered in the management and investment of the trust property to do any and all things that a natural person, free from

disability of every kind, might legally do with or in respect of such person's own property. Under the terms of the policy, the owner could elect to have the proceeds made payable according to various plans, use the loan value to pay the premiums, borrow on the policy, assign or pledge the policy, and elect to receive the annual dividends.

In 1974, *H* died and a successor trustee was named.

Section 2042(2) of the Code provides, in pertinent part, as follows:

> The value of the gross estate shall include the value of all property—
>
> * * * * *
>
> (2) RECEIVABLE BY OTHER BENEFICIARIES.—To the extent of the amount receivable * * * as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person.

Section 20.2042-1(c)(2) of the Estate Tax Regulations provides that:

> For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.

Section 20.2042-1(c)(4) of the regulations provides:

> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

In enacting section 811(g) of the Internal Revenue Code of 1939 (the predecessor of section 2042(2) of the 1954 Code), Congress introduced, but failed to define, the term "incidents of ownership." However, the Senate Finance Committee listed in its report the types of powers and interests that Congress meant to be included within the scope of the term. *S. Rep. No. 1631,* 77th Cong., 2d Sess. 235 (1942), 1942-2 C.B. 677. The powers and interests there listed are virtually the same as those now included in section 20.2042-1(c)(2) of the regulations.

At the time of the enactment of section 2042 of the Code, the Senate Finance Committee strongly inferred that Congress intended section 2042 to parallel the statutory scheme governing the interests and powers that will cause other types of property to be included in a decedent's estate under other Code sections, particularly sections 2036 and 2038. *S. Rep. No. 1622,* 83rd Cong., 2d Sess. 124 (1954). Under these sections, it is the decedent's power at the time of death to affect the beneficial interest or enjoyment of the property, or the income therefrom, that requires inclusion, even though the decedent had no right to receive any of the economic benefits.

That Congress had such an intent was recognized by the courts in *Skifter v. Commissioner,* 468 F. 2d 699 (2d Cir. 1972), a case involving an insured decedent's possession of certain incidents of ownership in a fiduciary capacity, and in *Lumpkin v. Commissioner,* 474 F. 2d 1092 (5th Cir. 1973), a case involving a decedent's incidents of ownership not held in a fiduciary capacity.

The court stated in *Lumpkin* that "by using the 'incidents of ownership' term Congress was attempting to tax the value of life insurance proceeds over which the insured at death still possessed a substantial degree of control." Then, drawing upon cases decided under the predecessors of sections 2036 and 2038 of the Code, the court concluded that the decedent possessed "substantial control" over the time and manner of enjoyment of the proceeds because of the right conferred upon him to elect optional modes of settlement (his only right) under a group term life insurance policy. The court held this right to be an incident of ownership within the meaning of section 2042(2) despite the fact that the decedent could not benefit himself or his estate. See *Rose v. United States,* 511 F. 2d 259 (5th Cir. 1975); *United States v. Rhode Island Hospital Trust Company,* 355 F. 2d 7 (1st Cir. 1966).

Further, the fact that a decedent's control over the insurance is subject to fiduciary restraints over its exercise does not automatically deprive it of the substantiality required for inclusion of the value of the proceeds in the gross estate. Section 20.2042-1(c)(4) of the regulations specifically provides that a decedent is considered to have an "incident of ownership" in a policy held in trust if the decedent has the power (as trustee or otherwise) to change the time or manner of enjoyment, even though the decedent has no beneficial interest in the trust.

In *Skifter,* the Court of Appeals for the Second Circuit concluded that section 20.2042-1(c)(4) of the regulations must be read to apply only to reservations of powers by the transferor as trustee. The Service will not follow this holding nor the dictum to the same effect in *Fruehauf v. Commissioner,* 427 F. 2d 80 (6th Cir. 1970). However, in *Lumpkin,* the Court of Appeals for the Fifth Circuit, in holding that the value of insurance proceeds was includible in the gross estate, stated that "it is enough if at death the decedent merely *possessed* an incident of ownership, the means by which he came into possessing being irrelevant." The principle of *Lumpkin* was again applied in *Rose,* another case involving incidents of ownership held in a fiduciary capacity, where the court pointed out:

> * * * Under section 2036 Congress specifically levied the estate tax upon interests *retained* by a decedent in connection with an incomplete transfer; and section 2038 is similar in effect. Under section 2042, however, Congress applied the tax to insurance over which a decedent *possessed* any inci-

dents of ownership. The difference in statutory language is significant. * * * We agree with the Second Circuit that section 2042 "roughly parallels" its cousin sections of the Estate Tax Code in regard to the substantiality of the decedent's control which is prerequisite to includibility in decedent's gross estate. But we cannot ignore Congress' conspicuous variety in statutory idiom, so as to make the tax treatment of insurance identical with the taxation of other interests: section 2042 was not drawn in terms to catch only *retained* incidents of ownership, and we find no basis to infer such a design. * * *

Similarly, the court in *Terriberry v. United States*, 517 F. 2d 286 (5th Cir. 1975), *cert. denied*, 44 U.S.L.W. 3530 (Mar. 22, 1976), held that the insurance proceeds on the decedent's life were includible in the decedent's gross estate under section 2042 of the Code where the decedent's wife transferred the policies to a revocable trust of which the decedent was a co-trustee.

In the instant case, the decedent, as trustee, through the right to elect optional modes of settlement, borrow on the policy, and withdraw dividends pursuant to the terms of the trust and the insurance policy, had a substantial degree of control over the time and enjoyment of the policy proceeds. Such control was an incident of ownership within the meaning of section 2042(2) of the Code.

Accordingly, since the insured-decedent possessed an incident of ownership in the insurance policy at the time of death, the proceeds of such insurance are includible in decedent's gross estate, even though held only in a fiduciary capacity.

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26 CFR 20.2042-1: Proceeds of life insurance.

Life insurance proceeds; split-dollar arrangements. Factual situations illustrate whether a decedent or the corporation controlled by the decedent possessed sufficient incidents of ownership in an insurance policy on the decedent's life, for which premium costs were shared under a split-dollar arrangement, to require inclusion in the gross estate of proceeds paid to the decedent's personal beneficiary.

Rev. Rul. 76-274

Advice has been requested as to the application of section 2042 of the Internal Revenue Code of 1954 in three factual situations involving "split-dollar" life insurance arrangements.

In each of the situations described below, the decedent was, at the date of death, a "controlling stockholder" in a corporation, as that term is defined in section 20.2042-1(c)(6) of the Estate Tax Regulations. In each situation a whole life policy of insurance was procured on the life of the decedent. A rider was attached to each policy that designated the "owner," "sub-owner," and "personal beneficiary" of the policy and specified the terms under which payment of the policy proceeds were divided between the "owner" and the "personal beneficiary."

Situation 1. The decedent applied for and obtained the insurance policy. The corporation simultaneously agreed to provide, at the beginning of each policy year, that portion of the annual premium which would equal the amount of the increase in the cash surrender value of the policy during the year, as a loan to the decedent. In order to secure the corporation as a lender of premium moneys, the policy rider designating the corporation as "owner" and the decedent as "sub-owner" was attached to the policy by the insurance carrier. A third party was named as personal beneficiary." The rider provided that upon death, the proceeds would be payable, first, to the "owner" in an amount equal to the current cash surrender value of the policy (less any indebtedness against the policy, including interest accrued thereon). The balance of the proceeds was payable to the designated "personal beneficiary."

The rider also provided that the "owner" had the power, among other things, to release, surrender, transfer or assign the policy without consent of the "sub-owner." The "sub-owner" was stated to possess the right to change the personal beneficiary and assign the "sub-owner's" interest in the policy.

More than three years prior to death, all the decedent's rights and interest in the policy as "sub-owner" were assigned to a third party. Payment of proceeds to the third party, who was also the "personal beneficiary," did not result in an increase in the net worth of the corporation.

Situation 2. In this situation, the facts are the same as in *Situation 1*, with two exceptions. First, the decedent did not assign the rights as "sub-owner" to a third party but rather retained them until death. Second, the rights of the corporation were severely restricted under the terms of the rider to (1) borrowing against the policy, up to the extent of the cash surrender value (but not in excess of its loans of premium moneys), and (2) assigning the "owner's" rights in the policy to the "sub-owner" upon payment of the premium moneys loaned by the corporation. The terms of the agreement between the decedent and the corporation and the terms of the policy rider clearly prohibited the corporation, as designated "owner," from taking any action that would endanger the interest of the "sub-owner" or payment of proceeds in excess of cash surrender value (less policy loans and interest thereon) to the "personal beneficiary" upon the decedent's death. The corporation was specifically prohibited from surrendering the policy for cancellation and from assigning its rights to anyone other than the "sub-owner." The "sub-owner" was specifically empowered to assign the rights of the "sub-owner," change the "personal beneficiary," and exercise settlement options, among other things. Except for those rights specifically granted to the "owner,"

the "sub-owner" was stated to possess the sole power to exercise all rights with respect to the policy.

Situation 3. The facts are the same as in *Situation 2*, except that a third party, who had an insurable interest in the life of the decedent under local law, originally obtained the insurance policy and entered the agreement with the corporation for partial payment of the premiums. The corporation was the designated "owner" under the policy rider and its rights with respect to the policy were restricted under the same terms as in *Situation 2*. The third party continued as "sub-owner" until the decedent's death. Payment of proceeds to the third party did not result in an increase in the net worth of the corporation.

Section 2042 of the Code provides that a decedent's gross estate shall include, in certain circumstances, proceeds of insurance on the life of the decedent. Where the proceeds are receivable by someone other than the decedent's executor, they are includible in the gross estate if the decedent possessed, at death, any of the incidents of ownership in the policy, whether exercisable alone or in conjunction with another person.

Section 20.2042-1(c)(2) of the regulations contains the following description of the term "incidents of ownership":

> For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. See subparagraph (6) of this paragraph for rules relating to the circumstances under which incidents of ownership held by a corporation are attributable to a decedent through his stock ownership.

Section 20.2042-1(c)(6) of the regulations contains the following provisions:

> In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholder, the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corporation for purposes of the preceding sentence. * * * Except as hereinafter provided with respect to a group-term life insurance policy, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent's stock holdings in the corporation for purposes of section 2031, any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through his stock ownership where the decedent is the sole or controlling stockholder. Thus, for example, if the decedent is the controlling stockholder in a corporation, and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership and the proceeds will be included in his gross estate under section 2042. If in this example the policy proceeds had been payable 40 percent to decedent's spouse and 60 percent to the corporation, only 40 percent of the proceeds would be included in decedent's gross estate under section 2042. For purposes of this subparagraph, the decedent will not be deemed to be the controlling stockholder of a corporation unless, at the time of his death, he owned stock possessing more than 50 percent of the total combined voting power of the corporation. * * *

In each of the situations described above, a portion of the proceeds of each insurance policy was payable to a designated "personal beneficiary" other than the corporation of which the insured decedent was the controlling stockholder. The question presented in each situation is whether that portion of proceeds is includible in the decedent's gross estate under section 2042 of the Code.

In *Situation 1*, the decedent's rights in the policy, as "sub-owner," were assigned to the third party who was the designated "personal beneficiary." The decedent died more than three years later.

The rights of the corporation in the policy, as "owner," were of substantial importance and extended to the entire policy. Under the terms of the policy rider, those rights included the right to surrender and assign the policy. The corporation thus possessed "incidents of ownership" in the policy as that term is defined in section 20.2042-1(c)(2) of the regulations (quoted above).

The portion of the proceeds payable to the third party was not payable for a valid business purpose, so the net worth of the corporation was not increased as a result of such payment. Therefore, since the decedent was a controlling stockholder of the corporation and since the corporation held incidents of ownership in the portion payable to the third party, the corporation's incidents of ownership are attributable to the decedent under section 20.2042-1(c)(6) of the regulations.

Accordingly, in *Situation 1*, the amount of proceeds not paid to the corporation but rather paid to the third party is includible in the decedent's gross estate under section 2042 of the Code.

In *Situation 2*, unlike the previous situation, the terms of the rider designating the corporation as the "owner" of the policy severely restricted the power of the corporation to deal with the policy. Its only incident of ownership was the right to recover its loan of premium moneys by borrowing against the cash surrender value. It could do nothing, as the rider clearly spelled out, to jeopardize the rights of the "sub-owner" or payment of the excess of the death benefit over cash value to the designated "personal beneficiary." The corporation, although nominally the "owner" of the policy, was thus, in substance, a secured lender. In view of the agreement between the decedent and the corporation, and in view of the terms

of the policy rider, the corporation is not considered to have possessed any incident of ownership in the portion payable to the "personal beneficiary" that would be required to be attributed to the decedent under section 20.2042-1(c)(6) of the regulations.

Nevertheless, the decedent in *Situation 2,* remained as "sub-owner" of the policy until death. The substantial control of the policy possessed by the "sub-owner," under the terms of the rider, amount to incidents of ownership possessed directly by the decedent at death without reference to the decedent's position as controlling stockholder.

Accordingly, in *Situation 2,* those proceeds payable to the "personal beneficiary" are includible in the decedent's gross estate under section 2042 of the Code.

In *Situation 3,* the facts are the same as those in *Situation 2,* except a third party originally obtained the policy of insurance on the decedent's life and entered the agreement with the corporation for sharing premium costs and policy proceeds. As in *Situation 2,* the corporation was prohibited by the rider and agreement from taking any action that might endanger the interest of the "sub-owner." Therefore, as in *Situation 2,* the corporation held no incident of ownership in the portion of proceeds payable to the "personal beneficiary," for the purposes of section 20.2042-1(c)(6) of the regulations.

Accordingly, in *Situation 3,* no amount is includible in the decedent's gross estate under section 2042 of the Code with respect to those proceeds payable to the "personal beneficiary," because neither the decedent nor the corporation of which the decedent was the controlling stockholder held incidents of ownership in that portion of the policy proceeds.

The three situations discussed above involve corporate split-dollar arrangements where the decedent or a third party obtained insurance on the decedent's life. In the event that some other type of split-dollar arrangement is entered into (such as one where the corporation originally obtains insurance on the decedent's life), the Federal estate tax consequences of such an arrangement would be the same as in the above three situations so long as the respective rights of the corporation and the other persons are fixed in the same manner as those described above.

Although the corporation agreed to pay only a portion of the annual insurance premiums in the three situations discussed above, the same Federal estate tax consequences would obtain regardless of the source or purpose of payment of policy premiums.

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26 CFR 20.2042-1: Proceeds of life insurance.

Life insurance; employer's plan; purchased and owned by third party. A decedent possesses no incident of ownership, within the meaning of section 2042 of the Code, in a life insurance policy purchased and owned by a third party under an employer's plan providing that optional insurance may be purchased by a qualified third party if the employee initially rejects such coverage and that the employee may later apply for insurance coverage if the third party ceases, for reasons other than death, to qualify as an eligible owner.

Rev. Rul. 76-421

Advice has been requested regarding the extent to which the value of the proceeds of a policy of insurance on the life of a decedent is includible in the decedent's gross estate, under section 2042 of the Internal Revenue Code of 1954, under the circumstances described below.

In 1974, *X* Company entered into an agreement with an insurance company providing for an optional contributory group insurance policy insuring the lives of its salaried employees. Only a salaried employee was entitled to be insured.

Under the terms of the insurance contract, the optional group life insurance on the life of a salaried employee becomes effective upon the completion of an enrollment election form by the employee and the payment of monthly premiums. In the event that an employee does not enroll for the optional life insurance, any person who qualifies as an "applicant owner" (certain specified adult relatives of the employee) may then enroll and pay the premiums for the optional life insurance on such employee. The employee must witness the enrollment form of the applicant owner, but thereafter the applicant owner under applicable state law is the sole owner of the insurance and possesses all incidents of ownership, including the right to assign and bequeath the insurance. If the applicant owner predeceases the employee, the ownership of the insurance policy vests in the applicant owner's estate. However, if an event occurs, other than the death of an applicant owner, that causes the applicant owner to no longer qualify as an applicant owner, the insurance coverage automatically terminates 30 days after such event. For example, if the applicant owner is the employee's spouse and their marriage is terminated by divorce, the insurance on the employee's life will terminate since the former spouse would no longer qualify as an applicant owner.

When insurance coverage ceases as a result of the loss of qualification of an applicant owner, the employee again becomes eligible to apply for coverage under the program, but only upon the completion of a new enrollment election form.

On June 1, 1974, the decedent's spouse, as an applicant owner, enrolled for insurance on the decedent's life under the optional group life insurance program. All premiums on the policy were paid with the separate

funds of the decedent's spouse. The decedent, a salaried employee of *X* Company, died on January 16, 1975.

Section 2042 of the Code provides that the value of the gross estate shall include the value of all property to the extent of the amount receivable as insurance under policies on the life of the decedent by (1) the executor, and (2) all other beneficiaries, with respect to which the decedent possessed at death any of the incidents of ownership in the policies, exercisable either alone or in conjunction with any person. For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law), but only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent.

Section 20.2042-1(c)(2) of the Estate Tax Regulations provides: "* * * the term 'incident of ownership' is not limited in its meaning to ownership of the policy in the technical legal sense. * * * Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. * * *"

Section 20.2042-1(c)(3) of the regulations provides that the term "reversionary interest" includes a possibility that the policy or its proceeds may return to the decedent or the decedent's estate and a possibility that the policy or its proceeds may become subject to a power of disposition by the decedent. The terms "reversionary interest" and "incidents of ownership" do not include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or a similar right.

For estate tax purposes, a reversionary interest in an insurance policy or the proceeds of an insurance policy, as an incident of ownership under section 2042 of the Code and the regulations, includes the possibility that the *policy* or the *proceeds* of the policy may return to the decedent or the *policy* or its *proceeds* may become subject to a power of disposition by the decedent.

While it is clear, by the express terms of the insurance contract, that the applicant owner's right to enroll for the optional group insurance on the decedent's life comes into being only upon the election of the decedent not to enroll in the program, the applicant owner's right, if exercised, entitles the applicant owner to sole ownership of the insurance. Neither the insured-decedent nor the insured-decedent's estate has the right to any of the economic benefits set forth in section 20.2042-1(c)(2) of the regulations as "incidents of ownership."

In the event that the insurance on the decedent's life terminates as a result of the cessation of the applicant owner's eligibility to own such insurance, the decedent is again eligible or again has the right to enroll for insurance coverage. What reverts to the decedent, in such instance, is not *insurance* or the *proceeds* of insurance as required by the Code, but rather the *right* to enroll for insurance coverage provided the decedent takes affirmative action by submitting a new enrollment election form. The possession by the decedent of such right to enroll for insurance on the decedent's life, or the possibility of reversion of such right is not an "incident of ownership," as that term is defined in sections 20.2042-1(c)(2) and 20.2042-1(c)(3) of the regulations.

Accordingly, in this case, the decedent died possessed of no incident of ownership in the policy of insurance on the decedent's life and no part of the proceeds is includible in the decedent's gross estate under section 2042 of the Code.

Part IV.—Taxable Estate

Section 2053.—Expenses, Indebtedness, and Taxes

26 CFR 20.2053-1: Deductions for expenses, indebtedness, and taxes; in general.

Expenses of funeral and last illness. Funeral expenses and expenses of the last illness of a wife are not deductible by her estate in those jurisdictions following the common law principle that a husband is primarily liable for such expenses unless a provision in her will relieves the husband of such obligation or he is insolvent. However, the expenses are deductible by the estate in those jurisdictions in which the estate of the decedent is primarily liable for such expenses. Rev. Rul. 65-300 superseded.

Rev. Rul. 76-369

Advice has been requested as to the application of section 2053 of the Internal Revenue Code of 1954 in two factual situations, described below, involving funeral expenses and expenses of the last illness of a deceased wife, survived by a husband.

Situation 1.—The statutory and decisional law of the jurisdiction where the wife's estate was administered follows the common law principle that a husband is primarily liable for the reasonable funeral expenses and expenses of the last illness of his wife, even if at the time of death the spouses were separated, and the wife's estate remains only secondarily liable. However, a wife may relieve her husband from this liability by providing in her will for the payment of the funeral expenses and expenses of the last illness out of her own estate. Nevertheless, such testamentary provision cannot be taken advantage of by the husband if he has elected to take against the will. Thus,

the local courts allow claims of this nature against the estate only when the deceased wife's will directs the payment of such expenses, or when there is no such direction but the husband is insolvent and the wife's estate becomes liable for the expenses.

Examples of decisional law in jurisdictions following *Situation 1* principles include: *Podbielski v. Argyle Bowl,* 44 Mich. App. 280, 205 N.W. 2d 240 (1973), *aff'd* 392 Mich. 380, 220 N.W. 2d 397 (1974), stating that, "It is well settled that a husband is bound to pay his wife's funeral expenses"; *Moran v. Le Blanc's Estate,* 256 Mich. 189, 239 N.W. 321 (1931), recognizing the common law rule, but which also allows recovery against the wife's estate pursuant to the terms of her will that provide for the payment of the funeral expenses; *Harris v. Berry,* 49 App. 235, 174 S.E. 813 (Ga. Ct. of App. 1934), stating that the husband's statutory liability for maintaining his wife and providing her with necessities includes liability for the wife's funeral; and *White's Estate,* 150 Neb. 167, 33 N.W. 2d 470 (1948), holding that the provision in a wife's will directing payment of all debts and funeral expenses relieved the husband of his primary obligation to pay and was in effect, a legacy, the benefit of which the husband waived by electing to take under statute of descent; hence, the husband after paying such expenses was not entitled to recover on a claim for reimbursement against the wife's estate.

Situation 2.—The statutory and decisional law of the jurisdiction where the wife's estate was administered provides that the estate of the decedent is, in all cases, primarily liable for funeral expenses, while both the widow and widower of an indigent deceased spouse are under a secondary duty to defray such expenses. The local courts allow the funeral expenses and expenses of the last illness as claims against the estate as long as the estate is solvent.

Examples of statutory and decisional law in jurisdictions following *Situation 2* principles include: *Kefover's Estate,* 112 Colo. 53, 145 P. 2d 879 (1944) holding that under state law the estate of a married woman was liable for her funeral expenses and the surviving husband, who had paid such expenses, was entitled to reimbursement from the wife's estate; *Skillman's Estate,* 146 Iowa 601, 125 N.W. 343 (1910), holding that, based on a family expense statute, where a wife predeceased her husband, her estate was liable for the expenses of her last sickness and funeral; *Foran v. Carangelo,* 153 Conn. 356, 216 A. 2d 638 (1966), applying the Connecticut statute that imposes liability for the funeral expenses of a married person on his or her estate; and *Rollman Estate,* 25 Fiduc. Rep. 633 (D.C., Comm. Pleas, Lancas. Co., Pa. 1975) holding that the prior law imposing a duty on a surviving husband to pay the expenses of his wife's funeral and last illness, even though she has an estate of her own, is unconstitutional under the "Equal Rights Amendment," Article I, Section 28 of the Pennsylvania Constitution. In this case, the court concluded that the estate of the decedent is, in all cases, primarily liable for funeral expenses, while both the widow and widower of an indigent spouse are under a secondary duty to defray such expenses.

Section 2053 of the Code authorizes the allowance as a deduction, from the value of a decedent's gross estate, of such amounts for funeral expenses and for claims against the estate as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered. In section 20.2053-1(a) of the Estate Tax Regulations, the phrase "allowable by the law of the jurisdiction" is defined to mean allowable by the law governing the administration of decedents' estates.

Accordingly, if the deceased wife executed a will and directed her executor to pay her funeral expenses and expenses of her last illness from estate assets and such items have been paid and allowed by the local court, then in both *Situation 1* and *Situation 2,* the amount thereof is allowable as a deduction from the gross estate for Federal estate tax purposes under section 2053 of the Code, whether the husband is solvent or insolvent.

On the other hand, if the deceased wife died intestate or executed a will without providing for payment of the funeral expenses and expenses of her last illness, then in *Situation 1,* the husband is liable for such expenses if he is solvent and the wife's estate is not entitled to a deduction under section 2053 of the Code; however, if the husband is insolvent at the time of the wife's death, then the wife's estate is liable for the expenses and a deduction is allowable under section 2053 for the expenses that are paid and approved by the local court as claims against the estate. In *Situation 2,* the estate is primarily liable for these expenses and a deduction under section 2053 is allowable for expenses that are paid and are properly allowable as claims against the estate by the local court.

Rev. Rul. 65-300, 1965-2 C.B. 375, is hereby superseded.

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26 CFR 20.2053-1: Deductions for expenses, indebtedness, and taxes; in general.

Treatment of trustees' fees paid by an estate to trustees of a grantor trust. See Rev. Rul. 76-498, page 199.

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26 CFR 20.2053-4: Deductions for claims against the estate; in general.

Veteran's personal property; passing to U.S. The value of a deceased veteran's personal property that passes to the U.S. pursuant to 38 U.S.C. 5220 is not deductible from the decedent's estate as a pledge under section 20.2053-5 of the regulations in a situation where the veteran was not competent to enter into a contract at any time while in a V.A. hospital, but is deductible as a liability imposed by law under section 20.2053-4.

Rev. Rul. 76-542

Advice has been requested as to the applicability of Rev. Rul. 75-533, 1975-2 C.B. 359, to the value of a deceased veteran's personal property that passes to the United States pursuant to the Veteran's Benefit Act, 38 U.S.C. 5220 (1970), where the veteran was hospitalized in a Veterans' Administration (V.A.) facility for a service-connected disability and was mentally incompetent at all times from admission to the hospital until death.

Rev. Rul. 75-533 holds that the value of property passing to the United States as a trustee for the General Post Fund pursuant to the provisions of 38 U.S.C. 5220(a) is (1) includible in the gross estate of the deceased veteran under section 2033 of the Internal Revenue Code of 1954, and (2) deductible in full as a claim against the estate for a charitable pledge pursuant to the provisions of section 20.2053-5 of the Estate Tax Regulations.

38 U.S.C. 5220 (1970) provides as follows:

> (a) Whenever any veteran (admitted as a veteran) shall die while a member or patient in any facility or any hospital while being furnished care or treatment therein by the Veterans' Administration, and shall not leave surviving him any spouse, next of kin, or heirs entitled, under the laws of his domicile, to his personal property as to which he dies intestate, all such property, including money and choses in action, owned by him at the time of death and not disposed of by will or otherwise, shall immediately vest in and become the property of the United States as trustee for the sole use and benefit of the General Post Fund (hereinafter in this subchapter referred to as the "Fund"), a trust fund prescribed by section 725s(a)(45) of title 31.
>
> (b) The provisions of subsection (a) are conditions precedent to the initial, and also to the further furnishing of care or treatment by the Veterans' Administration in a facility or hospital. The acceptance and the continued acceptance of care or treatment by any veteran (admitted as a veteran to a Veterans' Administration facility or hospital) shall constitute an acceptance of the provisions and conditions of this subchapter and have the effect of an assignment, effective at his death, of such assets in accordance with and subject to the provisions of this subchapter and regulations issued in accordance with this subchapter.

38 U.S.C. 5221 (1970) provides:

> The fact of death of a veteran (admitted as such) in a facility or hospital, while being furnished care or treatment therein by the Veterans' Administration, leaving no spouse, next of kin, or heirs, shall give rise to a conclusive presumption of a valid contract for the disposition in accordance with this subchapter but subject to its conditions, of all property described in section 5220 of this title owned by said decedent at death and as to which he dies intestate.

Section 2053 of the Code allows a deduction from the value of a decedent's gross estate for Federal estate tax purposes for claims against the decedent's estate that are allowable by the laws of the jurisdiction under which the estate is being administered. Section 2053(c)(1)(A) limits the deduction with respect to claims against the estate that are founded on a promise or agreement to the extent that such claims were contracted bona fide and for an adequate and full consideration in money or money's worth. However, if a claim is based upon a promise or agreement to make a contribution to a donee described in section 2055, the deduction is not limited to the extent that there was adequate and full consideration but is limited only to the extent that such claim would be allowable under section 2055 if such promise or agreement constituted a bequest.

Section 20.2053-4 of the regulations provides:

> The amounts that may be deducted as claims against a decedent's estate are such only as represent personal obligations of the decedent existing at the time of his death, whether or not then matured * * *. Only claims enforceable against the decedent's estate may be deducted. Except as otherwise provided in section 20.2053-5 with respect to pledges or subscriptions, section 2053(c)(1)(A) provides that the allowance of a deduction for a claim founded upon a promise or agreement is limited to the extent that the liability was contracted bona fide and for an adequate and full consideration in money or money's worth * * *. Liabilities imposed by law or arising out of torts are deductible.

Section 20.2053-5 of the regulations provides:

> A pledge or a subscription, evidenced by a promissory note or otherwise, even though enforceable against the estate, is deductible only to the extent that—
>
> (a) Liability therefor was contracted bona fide and for an adequate and full consideration in cash or its equivalent, or
>
> (b) It would have constituted an allowable deduction under section 2055 (relating to charitable, etc., deductions) if it had been a bequest.

The operation of section 20.2053-5 of the regulations is premised on the existence of a contract or agreement (actual, implied, or created by operation of law). Thus, such provision applies only with respect to property passing pursuant to 38 U.S.C. 5220 (1970) if the deceased veteran had been competent to enter into a valid contract under state law. Where, as in the instant case, the veteran was unable to enter into a valid contract with the United States because of mental incompetence at all times from the moment of admission to the V.A. facility until death at such facility, section 20.2053-5 does not apply.

On the other hand, section 20.2053-4 of the regulations provides that "[l]iabilities imposed by law or arising out of torts are deductible." The concept of allowing a deduction for a liability imposed by law was first incorporated into the regulations by Article 36 of Regulations 80. The regulation was designed to reflect the following statement in the committee report that accompanied the bill later enacted as the Revenue Act of 1932, such statement dealing with the intent of section 805 of the Act, a predecessor of section 2053(c)(1)(A) of the Code:

> (4) A clarifying provision limiting the requirement of an adequate and full consideration in money or money's worth to liabilities founded on contract. The existing law might be open to a construction under which no claim against the estate would be deductible unless supported by an "adequate and full consideration in money or money's worth," but the real intent could hardly have been to deny the deduction of liabilities imposed by law or arising out of torts, and the amendment whereby the requirement of a consideration applies only where the liability is founded on contract is designed to clear up any doubt which may be thought to exist. [*S. Rep No. 665*, 72d Cong., 1st Sess. 51

(1932), 1939-1 (Part 2) C.B. 491; accord, *H.R. Rep. No. 708,* 72d Cong., 1st Sess. 48 (1932), 1939-1 (Part 2) C.B. 533.]

The contractual language of 38 U.S.C. 5220(b) and 5221 provides an alternative basis for the passing of the decedent's property to the United States; under 38 U.S.C. 5220(a) (1970), the obligation is imposed solely by law, without any requirement of a contract or agreement. *United States v. Oregon,* 366 U.S. 643 (1961).

It is immaterial for Federal estate tax purposes whether the care and treatment provided a veteran by the V.A. was for a service-connected disability incurred or aggravated during a period of war. The V.A. is no more obligated to provide care and treatment to a veteran admitted to a V.A. facility for such a disability than it is obligated to provide care and treatment to a veteran admitted to a V.A. facility for any other disability, upon such veteran showing that "he is unable to defray the expenses of necessary medical care * * *. "38 U.S.C. 610 (1970); see *United States v. Automobile Club Insurance Co.,* 522 F. 2d 1, 3 (5th Cir. 1975); *United States v. St. Paul Mercury Indemnity Co.,* 238 F. 2d 594, 596-98 (8th Cir. 1956).

Accordingly, the value of the deceased veteran's personal property that passes to the United States pursuant to 38 U.S.C. 5220 is not deductible from the decedent's estate as a pledge within the scope of section 20.2053-5 of the regulations when the veteran was not competent to enter into a contract with the V.A. However, the value of such property is deductible in every case as a liability imposed by law within the meaning of section 20.2053-4 of the regulations. Since the statute does not require a contract, the competency of the decedent is not relevant.

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26 CFR 20.2053-8: Deductions for expenses in administering property not subject to claims.

Treatment of trustees' fees paid by an estate to trustees of a grantor trust. See Rev. Rul. 76-498, page 199.

Section 2055.—Transfers for Public, Charitable and Religious Uses

26 CFR 20.2055-2: Transfers not exclusively for charitable purposes. (Also Section 664; 1.664-1.)

Charitable remainder trust; deductible remainder interest. An otherwise qualifying testamentary trust providing for payment until the death or remarriage of the income beneficiary fails to qualify as a charitable remainder trust and no charitable deduction is allowable under section 2055(a) of the Code. A similar trust providing for a reduced payment upon the beneficiary's remarriage, with the balance of the beneficiary's share distributed to the charitable remainder beneficiaries, does qualify; however, no deduction is allowed for the value of the contingent unitrust amount payable to charity upon the beneficiary's remarriage.

Rev. Rul. 76-291

Advice has been requested whether a deduction is allowable under section 2055(a) of the Internal Revenue Code of 1954 with respect to a remainder interest in a testamentary trust payable to charity in the situations described below.

Situation 1. The decedent died in 1973. By the terms of a will executed in 1970, the decedent devised and bequeathed the residuary estate in trust. The trust provided that five percent of the net fair market value of the trust assets valued annually shall be paid annually in equal shares to *A* for life, to *B* for life, and to *C* until remarriage or death. Following this, the trust shall terminate and the assets distributed to the decedent's church and a hospital, both qualified organizations within the meaning of section 2055(a) of the Code.

Situation 2. Same facts as in *Situation 1,* except that in the event of *C*'s remarriage, *C*'s share shall be reduced to one percent, the balance of *C*'s share to be distributed to the charitable remainder beneficiaries.

The Tax Reform Act of 1969, Public Law 91-172, 1969-3 C.B. 10, added section 2055(e)(2) to the Code and imposed new requirements that must be satisfied by a charitable remainder trust in order to qualify for an estate tax charitable deduction. These amendments apply to decedents dying after December 31, 1969, who executed their wills after October 9, 1969. As amended, section 2055(e)(2) provides:

> Where an interest in property (other than a remainder interest in a personal residence or farm or an undivided portion of the decedent's entire interest in property) passes or has passed from the decedent to a person, or for a use, described in subsection (a), and an interest (other than an interest which is extinguished upon the decedent's death) in the same property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to a person, or for a use, not described in subsection (a), no deduction shall be allowed under this section for the interest which passes or has passed to the person, or for the use, described in subsection (a) unless—
>
> (A) in the case of a remainder interest, such interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664) or a pooled income fund (described in section 642(c)(5)), * * *.

Section 664(d)(2) of the Code, also added by the 1969 Act, defines a charitable remainder unitrust as a trust from which a fixed percentage (which is not less than 5 percent) of the net fair market value of its assets, valued annually, is to be paid not less often than annually, to one or more persons, at least one of which is not an organization described in section 170(c), for a term of years (not in excess of 20 years) or for the life or lives of such persons with an irrevocable remainder interest for the benefit of an organization described in section 170(c).

Section 1.664-1(a)(1)(i) of the Income Tax Regulations describes a

charitable remainder trust as a trust which provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or a term of years with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity.

Under section 1.664-1(a)(2) of the regulations, a trust is a charitable remainder trust only if it is either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect.

Section 1.664-3(a)(5) of the regulations provides that the period for which a unitrust amount is payable begins with the first year of the charitable remainder trust and continues for the life or lives of a named individual or named individuals or for a term of years not to exceed twenty years.

The terms "for life" or "for a term of years" in section 664(d)(2) of the Code and sections 1.664-1(a)(1)(i) and 1.664-3(a)(5) of the regulations are specific and unambiguous. They do not mean a measuring period of a life subject to termination by a condition subsequent, such as marriage or remarriage. Thus, since in *Situation 1* *C*'s interest may terminate by remarriage, the unitrust amount is not payable for the period of *C*'s life or for a term of years not to exceed twenty years, as required by the statute and regulations.

Accordingly, the testamentary trust created under the will of the decedent in *Situation 1* does not qualify as a charitable remainder trust under section 664 of the Code. Therefore, the trust does not meet the requirements of section 2055(e)(2) and no charitable deduction is allowable for Federal estate tax purposes under section 2055(a).

On the other hand, in *Situation 2* payment of the unitrust amount will continue throughout the lives of *A, B,* and *C,* as required by the statute and the regulations. Accordingly, the testamentary trust created under the will of the decedent in *Situation 2* qualifies as a charitable remainder unitrust under section 664 of the Code and a charitable deduction is allowable for the value of the charitable remainder interest. However, no deduction is allowable for the value of the contingent unitrust amount payable to charity upon the remarriage of *C*. See Rev. Rul. 76-225, 1976-1 C.B. 281.

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26 CFR 20.2055-2: Transfers not exclusively for charitable purposes.

Charitable remainder interest; personal residence. No charitable deduction is allowable under section 2055 of the Code for a remainder interest in a decedent's personal residence passing to charity upon the death of the decedent's child for whom the residence was held in a testamentary trust, valid under applicable local law, that is neither a charitable remainder annuity trust or unitrust nor a pooled income fund.

Rev. Rul. 76-357

Advice has been requested whether a charitable deduction is allowable under section 2055 of the Internal Revenue Code of 1954 with respect to a personal residence bequeathed by a decedent to a trust in which charity is given the remainder interest.

The decedent died testate on January 9, 1975. Under Item Four of the will, the decedent's personal residence is devised in trust to a corporate fiduciary. The trustee is directed to retain the personal residence during the life of the decedent's child. The child is to be allowed to occupy and use the premises without obligation to pay rent, so long as the child pays all expenses, such as local property taxes and repair costs, in connection with the property. The child is prohibited from assigning or anticipating the right to occupy the premises.

The trust will terminate upon the death of the child. At that time, the trustee must convey the residence to a named charitable organization that meets the requirements of section 2055(a) of the Code.

Under applicable local law, the decedent's trust is a valid testamentary trust. However, the trust is not a charitable remainder annuity trust or unitrust, as defined in section 664 of the Code; nor is it a pooled income fund, as defined in section 642(c)(5).

The question presented is whether a Federal estate tax charitable deduction is allowable with respect to the remainder interest of charity in the decedent's personal residence, in view of the fact that the residence is to be held in trust until the death of the decedent's child.

Section 2055(a) of the Code provides for a deduction with respect to the value of property passing to the various types of organizations described therein. Allowance of the deduction is limited in several ways, however. With respect to property in which both charitable and noncharitable beneficiaries receive interests, section 2055(e)(2) sets forth the following limitation:

> Where an interest in property (other than a remainder interest in a personal residence or farm or an undivided portion of the decedent's entire interest in property) passes or has passed from the decedent to a person, or for a use, described in subsection (a), and an interest (other than an interest which is extinguished upon the decedent's death) in the same property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to a person, or for a use, not described in subsection (a), no deduction shall be allowed under this section for the interest which passes or has passed to the person, or for the use, described in subsection (a) unless—
>
> (A) in the case of a remainder interest, such interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664) or a pooled income fund (described in section 642(c)(5)), or
>
> (B) in the case of any other interest, such interest is in the form of a guaranteed annuity or is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly).

Section 20.2055-2(e)(2)(ii) of the Estate Tax Regulations describes the

deductible charitable remainder interest in a personal residence as follows:

Remainder interest in personal residence. The charitable interest is a remainder interest, *not in trust,* in a personal residence. Thus, for example, if the decedent devises to charity a remainder interest in a personal residence and bequeaths to his surviving spouse a life estate in such property, the value of the remainder interest is deductible under section 2055. * * * (Emphasis added.)

Under the regulations, therefore, the statutory exception (to the general rule of section 2055(e)(2)(A) of the Code) for remainder interests in personal residences is not applicable if the personal residence is placed in trust by the decedent.

The following discussion is set forth at page 88 of Senate Report No. 91-552, 91st Congress, 1st Session (1969-3 C.B. 423, 480):

Another additional situation in which the committee amendments allow a charitable contribution deduction for the gift of a remainder interest to charity is in the case of a *nontrust* gift of a remainder interest in real property to charity. * * * (Emphasis added.)

In the present case, the decedent bequeathed the personal residence to a trustee and directed that the decedent's child have a lifetime right to occupy the premises before the property is to be conveyed to charity. The statutory exception in section 2055(e)(2) of the Code for remainder interests in personal residences is thus not applicable to the decedent's residence because it was placed in trust.

Accordingly, no deduction is allowable under section 2055 of the Code with respect to the remainder interest of charity under the trust to which the decedent's personal residence was devised.

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26 CFR 20.2055-2: Transfers not exclusively for charitable purposes.

Charitable remainder trust; post-1972 amendment by trustee. A charitable remainder trust executed before 1973, whose governing instrument was amended in 1975 by the trustee as provided by section 2055(e)(3) of the Code after the grantor's death earlier that year, may qualify as a charitable remainder unitrust, even though the amended instrument does not contain certain mandatory provisions which were suspended in certain cases by section 1.664-1(g)(2) of the regulations and a deduction for the remainder interest is not disallowed.

Rev. Rul. 76-370

Advice has been requested whether a charitable deduction for a remainder interest in trust is to be disallowed under section 2055(e)(2)(A) of the Internal Revenue Code of 1954 under the circumstances described below.

On February 1, 1970, the decedent executed a trust agreement under the terms of which the decedent retained an income interest for life. Upon decedent's death the trustee was directed to continue to hold the property in trust and to pay all debts, taxes and administrative expenses. After the payment of such items the trustee was directed to pay 5 percent of the net fair market value of the trust's assets determined annually to *A,* a noncharitable beneficiary, for life and upon *A*'s death to transfer the assets to the *M* charity, an organization described in sections 170(c), 2055(a) and 2522(a) of the Code.

Decedent died July 1, 1975, without having amended the trust after December 31, 1972. Prior to December 31, 1975, the trustee pursuant to section 2055(e)(3) of the Code amended the trust agreement. Under the terms of the amended agreement the original trust created on February 1, 1970, terminated after payment of decedent's debts, taxes and administrative expenses and the remaining trust assets were to be distributed to a second trust. The terms of the trust agreement complied with the requirements of section 664 of the Code and the regulations thereunder except the mandatory provisions made inapplicable to the governing instrument of certain charitable remainder annuity trusts and unitrusts by section 1.664-1(g)(2) of the Income Tax Regulations.

Held, a charitable remainder trust qualifies as a charitable remainder unitrust described in section 664(d)(2) of the Code when the governing instrument of such trust is amended for Federal estate tax purposes, after December 31, 1972, pursuant to and subject to the limitations of section 2055(e)(3) of the Code, even though the governing instrument as amended does not contain certain mandatory provisions which were suspended in certain cases by section 1.664-1(g)(2) of the regulations, and a deduction for the remainder interest is not disallowed under section 2055(e)(2)(A) of the Code.

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26 CFR 20.2055-2: Transfers not exclusively for charitable purposes.

Charitable remainder interest; split-interest trust with power of appointment. The estate of a decedent who executed a will and died after 1969 is not entitled to a charitable deduction under section 2055(a) of the Code for a remainder interest in a split-interest trust that was created under the will of a testator who died before 1970, granted the decedent a power of appointment, which the decedent failed to exercise, and provided, upon failure of the decedent to exercise the power, for a life estate to another party with the remainder payable to a charitable organization.

Rev. Rul. 76-504

Advice has been requested whether, under the circumstances described below, a deduction is allowable under section 2055(a) of the Internal Revenue Code of 1954 with respect to a remainder interest in a testamentary trust payable to charity.

The decedent's spouse, who died testate in 1968, created a testamentry trust under the terms of which the

decedent was given a life income interest and a general power to appoint the trust corpus by a will executed by the decedent after the spouse's death. By the terms of the spouse's trust instrument, if the decedent failed to appoint the trust corpus by will, then upon the decedent's death, the trust income was payable to *A* for life with the remainder payable to *X* Charity free of the trust.

The decedent died testate in 1975, holding the general power of appointment over the corpus of the trust created by decedent's spouse. Under the terms of decedent's will executed in 1974, the decedent failed to specifically appoint the trust corpus, either directly by a specific designation of alternate takers or indirectly by an effective residuary clause in the will. The decedent was survived by *A* who was given the secondary life estate in the trust.

Section 2041(a)(2) of the Code provides that the value of a decedent's gross estate shall include the value of all property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942. Under this Code section, the existence of the power, regardless of whether it is exercised, is the basis for including the property subject to the general power of appointment.

Section 2055(a) of the Code allows a deduction from the gross estate for a bequest, legacy, devise or transfer for public, charitable, religious, etc., purposes. Section 2055(b)(1) provides that if property is includible in a decedent's gross estate under section 2041 and the property so included passes to a charitable donee described in section 2055(a), then for the purposes of section 2055, such property interest shall be considered a bequest by the decedent-power holder (in whose estate the property is included).

The Tax Reform Act of 1969, Pub. L. 91-172, 1969-3 C.B. 10, added section 2055(e)(2) to the Code and imposed new requirements that must be satisfied by a charitable remainder trust in order to qualify for an estate tax charitable deduction. These amendments apply to decedents dying after December 31, 1969, who executed their wills after October 9, 1969. Section 2055(e)(2) provides:

> Where an interest in property (other than a remainder interest in a personal residence or farm or an undivided portion of the decedent's entire interest in property) passes or has passed from the decedent to a person, or for a use, described in subsection (a), and an interest (other than an interest which is extinguished upon the decedent's death) in the same property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to a person, or for a use not described in subsection (a), no deduction shall be allowed under this section for the interest which passes or has passed to the person, or for the use, described in subsection (a) unless —
>
> (A) in the case of a remainder interest, such interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664) or a pooled income fund (described in section 642(c)(5)) * * *.

Section 664 of the Code, also added by the 1969 Act, and section 1.664-1 of the Income Tax Regulations thereunder, define a charitable remainder annuity trust, in general, as a trust from which an annual sum certain, not less than 5 percent of the initial fair market value of all property placed in the trust, is to be paid to the income beneficiaries. A charitable remainder unitrust is essentially similar to an annuity trust, except that the amounts to be paid the income beneficiary are measured not by a fixed sum certain, but by a percentage—not less than 5 percent—of the net fair market value of the trust assets determined annually.

A pooled income fund is a trust maintained by, or on behalf of, the charitable organization(s) to which the remainder interest is contributed.

In the instant case, the corpus of the trust created in 1968 by the decedent's spouse is required to be included in the decedent's gross estate under section 2041(a)(2) of the Code. By virtue of section 2055(b)(1), the remainder interest in the trust bequeathed to *X* Charity after *A*'s life estate is deemed to result from a transfer made by the decedent after December 31, 1969, under a will executed after October 9, 1969. Accordingly, since the remainder interest transferred to charity is not a remainder interest in a personal residence or farm, and since it is not a remainder interest in a charitable remainder annuity trust or in a charitable remainder unitrust or in a pooled income fund, no deduction is allowable under section 2055(a) in respect of the remainder interest transferred to *X* Charity.

Further, the result in this case would be the same had the decedent died intestate.

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26 CFR 20.2055-2: Transfers not exclusively for charitable purposes.

Charitable remainder interest in personal residence; partial interest in sale proceeds. No charitable deduction is allowable under section 2055 for a remainder interest in a decedent's personal residence bequeathed to charity under a will which provides that the remainder is to be sold upon the life tenant's death and a part of the sale proceeds is to be paid to charity.

Rev. Rul. 76-543

Advice has been requested whether, in the circumstances described below, a charitable deduction is allowable under section 2055 of the Internal Revenue Code of 1954 for the value of an interest bequeathed to charity.

The decedent died on May 24, 1976, leaving a will executed on January 1, 1976. Article one of the will directs the payment of all taxes, debts, funeral expenses, and expenses of administration; and Article Two

devises the decedent's personal residence, Blackacre, to *B* for life. Article Three of the will directs that at the death of *B*, Blackacre is to be sold and $10,000 of the proceeds is to be distributed to *C*, a charitable institution within the meaning of sections 170(c), 2522, and 2055(a) of the Code. The remainder of the sale proceeds is to pass under the residuary clause of the will.

In determining the value of the taxable estate for Federal estate tax purposes, section 2055(a) of the Code provides for a deduction of amounts passing to or for the use of the organizations, persons and purposes described in section 2055(a), such as certain charitable organizations. However, with respect to decedents dying after December 31, 1969, section 2055(e)(2) provides that where a decedent transfers a remainder interest in property (other than a remainder interest in a personal residence or farm or an undivided portion of the decedent's entire interest in property) to a person or for a use described in section 2055(a) for the benefit of charity, and an interest in the same property is transferred to a person or for a use not described in section 2055(a), no deduction is allowed with respect to the charitable interest unless, in the case of a remainder interest, such interest is in either a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664) or a pooled income fund (described in section 642(c)(5)).

Since the remainder interest bequeathed to charity is clearly not in a charitable remainder annuity trust or unitrust, or in a pooled income fund, the specific question is whether charity's interest is a remainder interest in a personal residence in view of the fact that the residence is to be sold upon the life tenant's death and a part of the sale proceeds is to be paid to charity.

Under section 20.2055-2(e) of the Estate Tax Regulations, a deductible remainder interest in a personal residence is defined as follows:

> (ii) *Remainder interest in personal residence.* The charitable interest is a remainder interest, not in trust, in a personal residence. Thus, for example, if the decedent devises to charity, a remainder interest in a personal residence and bequeaths to his surviving spouse a life estate in such property, the value of the remainder interest is deductible under section 2055. For purposes of this subdivision, the term "personal residence" means any property which was used by the decedent as his personal residence even though it was not used as his principal residence. For example, a decedent's vacation home may be a personal residence for purposes of this subdivision. The term "personal residence" also includes stock owned by the decedent as a tenant-stockholder in a cooperative housing corporation * * * if the dwelling which the decedent was entitled to occupy as such stockholder was used by him as his personal residence.

The Senate Finance Committee Report pertaining to section 2055(e) of the Code, and the various limitations therein, states as follows:

> [A] situation in which the committee amendments allow a charitable contribution deduction for the gift of a remainder interest to charity is in the case of a nontrust gift of a remainder interest in real property to charity. Thus, for example, a charitable contribution deduction is to be allowed where an individual makes a gift of his *residence* to charity and retains the right to live in the residence for his life. * * * (Emphasis added.)

S. Rep. No. 91-552, 91st Cong., 1st Sess. 88(1969), 1969-3 C.B. 480.

Section 2055(e)(2) of the Code is applicable in the instant case because an interest in property has passed from the decedent for private purposes (the life interest devised to *B*) and an interest in the same property has also passed for charitable purposes (the charitable bequest of an interest in the sale proceeds at *B*'s death). The section 2055(e)(2) exception for remainder interests in personal residences, however, is not applicable. The personal residence exception in section 2055(e) is to apply only where a decedent devises the decedent's personal residence to charity with a preceding life estate in the decedent or another. *The charitable remainder interest must be in the residence itself and not in the proceeds to be derived from the sale of the residence at a future date.*

Accordingly, since charity was not given a remainder interest in the decedent's personal residence itself, no deduction is allowable under section 2055 of the Code.

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26 CFR 20.2055-2: Transfers not exclusively for charitable purposes.

Charitable remainder interest in personal residence; partial interest. No charitable deduction is allowable under section 2055 for a remainder interest in a decedent's personal residence that, upon termination of a life estate, vested in a charitable organization and an individual as equal tenants in common because the charity was not given the entire remainder interest.

Rev. Rul. 76-544

Advice has been requested whether, under the circumstances described below, a charitable deduction is allowable under section 2055 of the Internal Revenue Code of 1954 for the value of an interest in property bequeathed to charity.

The decedent died on June 24, 1976, leaving a will executed on March 1, 1976. Article One of the will directs the payments of all taxes, debts, funeral expenses, and expenses of administering the decedent's estate. Article Two devises the decedent's personal residence, Whiteacre, to *A* for life; and Article Three directs that the death of *A*, Whiteacre is to vest in *B*, a charitable institution within the meaning of sections 170(c), 2522, and 2055(a) of the Code, and in *C*, an individual, as equal tenants in common.

In determining the value of the taxable estate for Federal estate tax purposes, section 2055(a) of the Code provides for a deduction of amounts passing to or for the use of the organizations, persons and purposes de-

scribed in section 2055(a), such as certain charitable organizations. However, with respect to decedents dying after December 31, 1969, section 2055 (e)(2) provides that where a decedent transfers a remainder interest in property (other than a remainder interest in a personal residence or farm or an undivided portion of the decedent's entire interest in property) to a person or for a use described in section 2055(a) for the benefit of charity, and an interest in the same property is transferred to a person or for a use not described in section 2055 (a), no deduction is allowed with respect to the charitable interest unless, in the case of a remainder interest, such interest is in either a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664) or a pooled income fund (described in section 642(c)(5)).

Since the decedent did not bequeath to charity an undivided portion of the decedent's entire interest in the residence, and since the remainder interest therein bequeathed to charity is not in a charitable remainder annuity trust or unitrust, or in a pooled income fund, the specific question is whether charity's interest is a remainder interest in a personal residence in view of the fact that, at the death of the life tenant, the residence is to vest in charity and in a private individual as equal tenants in common.

Under section 20.2055-2(e) of the Estate Tax Regulations, a deductible remainder interest in a personal residence is defined as follows:

(ii) *Remainder interest in personal residence.* The charitable interest is a remainder interest, not in trust, in a personal residence. Thus, for example, if the decedent devises to charity a remainder interest in a personal residence and bequeaths to his surviving spouse a life estate in such property, the value of the remainder interest is deductible under section 2055. For purposes of this subdivision, the term "personal residence" means any property which was used by the decedent as his personal residence even though it was not used as his principal residence. For example, a decedent's vacation home may be a personal residence for purposes of this subdivision. The term "personal residence" also includes stock owned by the decedent as a tenant-stockholder in a cooperative housing corporation * * * if the dwelling which the decedent was entitled to occupy as such stockholder was used by him as his personal residence.

The Senate Finance Committee Report pertaining to section 2055(e) of the Code, and the various limitations therein, states as follows:

[A] situation in which the committee amendments allow a charitable contribution deduction for the gift of a remainder interest to charity is in the case of a nontrust gift of a remainder interest in real property to charity. Thus, for example, a charitable contribution deduction is to be allowed where an individual makes a gift of his *residence* to charity and retains the right to live in the residence for his life. * * * (Emphasis added.)

S. Rep. No. 91-552, 91st Cong., 1st Sess. 88 (1969), 1969-3 C.B. 480.

Section 2055(e)(2) of the Code is applicable in the instant case because an interest in property has passed from the decedent for private purposes (the life interest devised to *A*) and an interest in the same property has also passed for charitable purposes (the bequest of a partial interest in the residence at *A*'s death). The section 2055(e)(2) exception for remainder interests in personal residences, however, is not applicable. The personal residence exception in section 2055(e) is to apply only where a decedent devises the decedent's personal residence to charity with a preceding life estate in another. *Upon the lapse of the intervening life estate the charity must own the entire residence.*

Accordingly, since charity was not given the entire remainder interest in the decedent's personal residence, no deduction is allowable under section 2055 of the Code.

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26 CFR 20.2055-2: Transfers not exclusively for charitable purposes.

Charitable remainder interest; death of income beneficiary. A charitable deduction is allowable for the value of a charitable remainder interest in a split interest trust, which did not meet the requirements of section 2055(e)(2)(A) of the Code and was not amended or conformed to meet that section, that passed directly to the charity upon the death of the noncharitable income beneficiary prior to the due date of the decedent's estate tax return.

Rev. Rul. 76-545

Advice has been requested whether a deduction is allowable under section 2055(a) of the Internal Revenue Code of 1954 for the bequest to charity, under the circumstances described below.

Under the provisions of decedent's will executed in 1971, the residue of decedent's estate was to be placed in trust. The trust income was payable to decedent's spouse for life and the remainder payable to a charitable organization described in section 2055 (a) of the Code upon the death of the spouse. The decedent died on January 9, 1974. Decedent's spouse died on September 25, 1974, shortly before the filing date of decedent's estate tax return on October 9, 1974.

Section 2055(a) of the Code provides, in part, that in determining the taxable estate of a decedent, there shall be deducted from the value of the gross estate the amount of all bequests, legacies, devises, or transfers to be used exclusively for certain religious, charitable, scientific, literary, or educational purposes.

Section 2055(e)(2)(A) of the Code provides that in the case of decedents dying after December 31, 1969, no charitable deduction is allowable where an interest in property passes or has passed from the decedent for a charitable purpose, and an interest in the same property passes or has passed for a noncharitable purpose, unless in the case of a remainder interest, such interest is in the form of a charitable remainder annuity trust

or a charitable remainder unitrust (described in section 664) or a pooled income fund (described in section 642 (c)(5)).

In the event that the charitable interest created in a will executed before December 31, 1977, does not qualify for a deduction at the time of the decedent's death because the charitable interest (as described in section 2055(a)) does not meet the requirements of section 2055(e)(2)(A), section 2055(e)(3), as amended by section 1304(a) of the Tax Reform Act of 1976, P.L. 94-455, [1976-3 C.B.] provides, in part:

> [I]f the governing instrument is amended or conformed on or before December 31, 1977, or, if later, on or before the 30th day after the date on which judicial proceedings begun on or before December 31, 1977 (which are required to amend or conform the governing instrument), become final, so that the interest is in a trust which is a charitable remainder annuity trust, or a charitable remainder unitrust (described in section 664), or a pooled income fund (described in section 642(c)(5)), a deduction shall nevertheless be allowed. * * * If, by the due date for the filing of an estate tax return (including an extension thereof), * * * the interest passes directly to a person or for a use described in subsection (a), a deduction shall be allowed as if the governing instrument was amended or conformed under this paragraph.

Section 24.1(h) of the Temporary Estate Tax Regulations, 24 C.F.R. section 24.1 (1975), promulgated prior to enactment of the Tax Reform Act of 1976, provides, in part:

> (1) In the case of a will executed before September 21, 1974, * * * that creates an interest for which a deduction would be allowable under section 2055(a) but for section 2055(e)(2)(A), if the date of death of the decedent is prior to January 1, 1976, and if on or before the filing date of the estate tax return (including any extension thereof)—
>
> * * * * *
>
> (ii) Such interest passes directly to a person or for a use described in section 2055(a) (as, for example, by reason of the termination of an intervening interest),
>
> the governing instrument shall be treated as if it were amended or conformed pursuant to paragraph (a) of this section and a deduction shall be allowed. * * *
>
> (2) The amount of the deduction for a transfer which is treated under this paragraph as if it were amended will be determined as if the transfer were a charitable remainder annuity trust which provides an annuity of six percent of the initial fair market value payable from the date of death—
>
> (i) In the case of a transfer providing a life estate, for the expected lives of the noncharitable beneficiaries as determined on the date of death of the decedent, * * *

In the instant case, the charitable remainder interest created under the terms of the decedent's will was not in a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. Thus, at the date of decedent's death the charitable interest did not meet the requirements of section 2055(e)(2)(A) of the Code and did not qualify for a deduction. However, upon the death of the noncharitable income beneficiary and the resulting termination of the noncharitable interest, prior to the due date of the decedent's estate tax return, decedent's residuary estate passed directly to charity, thereby coming within the limited exception provided in section 2055(e)(3) of the Code.

Accordingly, a deduction is allowable under section 2055(a) of the Code for the value of the remainder interest passing to charity as if the governing instrument were amended to meet the requirements of section 2055(e)(2)(A). The amount of the deduction is to be determined as if the transfer were to a charitable remainder annuity trust that provides an annuity of six percent of the initial fair market value of the trust corpus payable from the date of death of the decedent for the expected life of decedent's surviving spouse as determined on the date of death of the decedent. See section 1.664-2(c) of the Income Tax Regulations.

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26 CFR 20.2055-2: Transfers not exclusively for charitable purposes.

Charitable remainder unitrust; death as disclaimer of life beneficiary's interest. The death of the life beneficiary of a charitable remainder unitrust, before the due date of the decedent-grantor's estate tax return and before any distributions have been made, is not equivalent to a disclaimer of such interest or a termination of a power to consume or invade the property for purposes of section 2055(a) of the Code.

Rev. Rul. 76-546

Advice has been requested whether the death of the beneficiary of an income interest in a charitable remainder unitrust prior to the due date of the estate tax return of the decreased grantor is (1) a disclaimer of such interest or (2) the termination of a power to consume, invade, or appropriate property for the benefit of an individual within the meaning of section 2055(a) of the Internal Revenue Code of 1954.

The decedent died testate on April 2, 1974. The decedent's will provided for the creation of a trust satisfying the requirements of a charitable remainder unitrust described in section 664(d)(2) of the Code. The terms of the trust provide that upon the death of the decedent a unitrust amount equal to ten percent of the net fair market value of the trust asssets, determined annually, shall be paid to decedent's surviving spouse for life. Upon the death of the surviving spouse, the trust will terminate and the remaining trust property shall be paid to a designated charitable organization.

The decedent's spouse died on May 2, 1974, just thirty days after the date of decedent's death and before any distribution had been made pursuant to decedent's will.

As worded before enactment of section 2009(b) of the Tax Reform Act of 1976 on October 4, 1976 (Public Law 94-455 [1976-3 C.B.]), section 2055(a) of the Code provides, in part, as follows:

> [T]he value of the taxable estate shall be determined by subtracting from the value

of the gross estate the amount of all bequests, legacies, devises, or transfers (including the interest which falls into any such bequest, legacy, devise, or transfer as a result of an irrevocable disclaimer of a bequest, legacy, devise, transfer, or power, if the disclaimer is made before the date prescribed for the filing of the estate tax return)—

* * * * *

(2) to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, * * *.

* * * * *

For purpose of this subsection, the complete termination before the date prescribed for the filing of the estate tax return of a power to consume, invade, or appropriate property for the benefit of an individual before such power has been exercised by reason of the death of such individual or for any reason shall be considered and deemed to be an irrevocable disclaimer with the same force and effect as though he had filed such irrevocable disclaimer.

Section 20.2055-2(c) of the Estate Tax Regulations under the statutory law quoted above provides that the amount of a bequest, for which a deduction is allowable under section 2055 of the Code, includes an interest which falls into the bequest as the result of either (1) an irrevocable disclaimer by a beneficiary prior to the date prescribed for filing the estate tax return, or (2) the complete termination of a power to consume, invade or appropriate property for the benefit of an individual, whether the termination occurs by reason of death or otherwise, if the termination occurs within the time for filing the estate tax return and before the power is exercised. With respect to the estates of decedents who died prior to December 31, 1976, a disclaimer is a complete and unqualified refusal to accept the rights to which one is entitled, made prior to acceptance of such rights, expressly or impliedly.

While it is true that the death of a life beneficiary may have the same effect as an irrevocable disclaimer of a life interest by the beneficiary, i.e., the passing of the life interest directly to the remainderman, the definition of the term "disclaimer" envisions a conscious, voluntary act. Thus, death is not equivalent to a disclaimer, *City National Bank and Trust Co. of Columbus* v. *United States,* 203 F. Supp. 398 (1962), *aff'd,* 312 F. 2d 188 (6th Cir. 1963), *cert. denied,* 373 U.S. 949 (1963).

That Congress itself realized that death is not equivalent to a disclaimer is evidenced by the fact that Congress felt it necessary to explicitly add to section 2055(a) of the 1954 Code (which otherwise corresponds to section 812(d) of the 1939 Code) the provision for treating a termination of a power due to the death of the donee of the power as a disclaimer that would qualify an otherwise nondeductible gift to charity for the charitable deduction. See 100 *Cong. Rec.* 9496 (remarks of Senator Martin).

Section 2055(a) of the Code and the regulations thereunder provide for death to operate as a disclaimer *only* with respect to a *power to consume, invade, or appropriate* property; it does not apply to other interests.

Accordingly, the death of the beneficiary of a life interest in a charitable remainder unitrust before the estate tax return of the decedent-grantor is due is not a disclaimer of such interest or the termination of a power to consume, invade, or appropriate property that operates as a disclaimer for the purposes of section 2055(a) of the Code. The amount of the charitable deduction allowable is the present value of the remainder interest in the charitable remainder unitrust determined under section 1.664-4 of the Income Tax Regulations.

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26 CFR 20.2055-2: Transfers not exclusively for charitable purposes.

Whether deductions for charitable contributions for property transferred to a charitable remainder trust are allowable. See Rev. Rul. 76-307, page 56.

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26 CFR 20.2055-3: Death taxes payable out of charitable transfers.

Charitable contribution; residue of estate. The amount allowable as a charitable deduction under section 2055 of the Code for the estate of a New York decedent, who had specified that all taxes would be paid from the residue of the estate after certain payments had been made and that the remainder would be divided equally between a charitable organization and the decedent's son, but had issued no clear, unambiguous direction against statutory apportionment of death taxes between the beneficiaries, is not reduced by any portion of the State and Federal estate taxes payable on such residue, and such taxes are allocable to the portion of the estate bequeathed to the son.

Rev. Rul. 76-358

Advice has been requested as to the amount allowable as a charitable deduction under section 2055 of the Internal Revenue Code of 1954 where the bequest to charity was made by a New York decedent in the circumstances described below.

The decedent, *D*, died in 1975. *D* was a resident of New York State and all property owned by *D* was located there.

The decedent's gross estate, for Federal and New York purposes, is $550,000, composed entirely of probate assets. The debts of the decedent and the funeral and administration expenses of the estate amount to $50,000.

Item II of the decedent's will is as follows:

I direct that all my just debts and funeral expenses be paid as soon after my death as may be practicable and that all estate taxes, both state and Federal, imposed upon property passing outside of, as well as under this, my will, be paid from my residuary estate.

Item III of the will provides that $200,000 be distributed to the decedent's daughter, *E*.

Under Item IV of the will, the residue of the estate is to be divided equally between a charitable organization (as described in section 2055(a)

of the Code) and the decedent's son, *F*.

The question presented is what amount is allowable as a charitable deduction for Federal estate tax purposes in view of the direction for payment of taxes in Item II of the decedent's will.

Section 2055(a) of the Code provides for a deduction from the Federal gross estate with respect to property passing from a decedent to a charitable organization described in section 2055(a). Under section 2055(c), the amount otherwise allowable as a deduction shall be reduced by the amount of any estate or inheritance taxes payable out of the charitable bequest.

Section 2-1.8 of the Estates, Powers and Trusts Law of New York provides, in part, as follows:

> (a) Whenever it appears in any appropriate action or proceeding that a fiduciary has paid or may be required to pay an estate or other death tax, * * * the amount of the tax, except in a case where a testator otherwise directs in his will, * * * shall be equitably apportioned among the persons interested in the gross tax estate * * *.

The New York estate tax is set forth in Article 26 of the New York Tax Law. Section 954, therein defines the New York gross estate of a deceased resident as the Federal gross estate (with certain modifications). The deductions allowed under New York law are, as provided in section 955, the same as those allowed under the Federal estate tax law (with certain adjustments), except that no $60,000 exemption is allowed. Section 958 of the New York Tax Law allows a percentage credit against the New York tax with respect to, among other things, property passing to a decedent's child. Under section 2-1.8(c)(2) of the New York Estates, Powers and Trust Law, an exemption based on the relationship of a beneficiary to the decedent shall inure to the benefit of the beneficiary in the event that the tax burden is equitably apportioned among the beneficiaries.

The case of *Will of Shubert,* 10 N.Y. 2d 461, 225 N.Y.S. 2d 13, 180 N.E. 2d 410 (1962), involved the following provision in a decedent's will:

> I direct that all estate, inheritance, succession, transfer or similar taxes on my estate passing under this Will shall be paid out of my residuary estate.

The executors in *Shubert* instituted proceedings to determine, among other things, how the New York statute requiring apportionment of tax burdens might be applicable in the case. The Surrogate held that although the will exonerated the preresiduary legatees from any tax burden, the above-quoted clause did not amount to an express direction against apportionment, within the residue, of the tax burden generated by the interests in the residue, part of which was bequeathed to a charitable foundation. In affirming the Surrogate's order, the Court of Appeals held that apportionment of taxes is required unless the will provides otherwise in clear, unambiguous terms. A general direction to pay taxes out of the residue was held *not* to prohibit statutory apportionment of taxes *within* the residue. The court cited numerous decisions on similar tax payment clauses, including *Mattes' Estate,* 205 Misc. 1098, 130 N.Y.S. 2d 270 (1954), *aff'd.,* 285 App. Div. 867, 137 N.Y.S. 2d 836, *aff'd,* 309 N.Y. 942, 132 N.E. 2d 314 (1955), where a similar clause and a residuary bequest to a surviving spouse were involved.

In *Lewald v. United States,* 245 F. Supp. 336 (S.D. N.Y. 1965), a decedent's will was held not to set forth a clear direction against apportionment within the residuary estate (three-fourths of which passed to the surviving spouse). Thus, no part of the tax burden generated by residuary bequests was imposed on the deductible surviving spouse's residuary interests.

In the present case, *D*'s will contains no clear, unambiguous direction against statutory apportionment of death taxes between the beneficiaries of the residue. Therefore, as in the court decisions discussed above, New York law requires that the Federal and New York taxes from which the pre-residuary beneficiary, *E* is exonerated be subtracted from the overall residue and that the balance of those tax liabilities be imposed upon *F*, the non-charitable residuary beneficiary whose interest gives rise to those taxes. The amount of the Federal charitable deduction computed under section 2055(c) of the Code (above) is thus 50 percent of the residue after subtraction of the Federal and New York estate taxes from which the pre-residuary beneficiary, *E*, is exonerated.

Accordingly, the amount allowable as a charitable deduction under section 2055 of the Code is $116,138.26, for which the computation results are provided below.

1. Charitable deduction.			
Gross estate			$550,000.00
Less: (a) Debts, expenses	$ 50,0000.00		
(b) Bequest to *E*	200,000.00		
(c) Fed. tax attributable to *E*'s bequest	57,924.55		
(d) N.Y. tax attributable to *E*'s bequest	9,798.94		317,723.49
Residue after taxes on pre-residuary items			$232,276.51
Times: Proportion passing to charity			×.50
Charitable deduction amount			$116,138.26
2. Federal estate tax.			
Gross estate			$550,000.00
Less: (a) Debts, expenses deductions	$ 50,000.00		
(b) Charitable deduction	116,138.26		
(c) Exemption	60,000.00		226,138.26

Federal taxable estate		$323,861.74
Federal tax thereon (after full credit for State death tax):		$ 83,052.18
3. New York estate tax.		
Federal taxable estate		$323,861.74
Plus: Fed. exemption (not allowed by N.Y.)		60,000.00
New York taxable estate		$383,861.74
Gross N.Y. tax thereon (before exemption-credits):		$ 14,193.09
Less: Exemption-credits re: bequests to 2 children of decedent		200.00
Net New York tax		$ 13,993.09
4. Apportionment of Federal tax to *E*'s bequest.		
Amount of bequest		$200,000.00
Plus: (a) Fed. tax attributable to bequest	$ 57,924.55	
(b) N.Y. tax attributable to bequest	9,798.94	67,723.49
Total benefit to *E*, to which taxes are attributed		$267,723.49
Divided by: Fed. taxable estate plus exemption		÷ 383,861.74
Apportionment ratio		.69744771
Times: Total Fed. tax		× $ 83,052.18
Federal tax attributable to bequest:		$ 57,924.55
5. Apportionment of N.Y. tax to *E*'s bequest.		
Apportionment ratio (above)		.69744771
Times: Gross N.Y. tax		× 14,193.09
Gross tax attributable to bequest		$ 9,898.94
Less: Exemption-credit on bequest		100.00
New York tax attributable to bequest		$ 9,798.94

The above solution is the product of an interrelated computation of the charitable deduction, Federal tax, and New York tax, based on the methods described in the Supplemental Instructions for the Federal Estate Tax Return (Form 706). Note that the amounts subtracted from the gross estate in (1), above, with respect to Federal and New York taxes are not the total amounts of those taxes but the portions thereof attribuable to the pre-residuary bequest to *E*. As a result, the interest of charity in 50% of the residue is not burdened with any of the taxes generated by *F*'s interest in the other half of the residue.

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26 CFR 20.2055-3: Death taxes payable out of charitable transfers.

Charitable contribution; residue of estate. The amount allowable as a charitable deduction under section 2055 of the Code to the estate of a New York decedent, whose will specified that all taxes were to be paid out of the residue of the estate as an expense of administration, that no part of such taxes was to be apportioned to any beneficiary, and that the remainder was to be divided equally between a charitable organization and the decedent's son, is one-half the residue of the estate after payment of all taxes.

Rev. Rul. 76-359

Advice has been requested as to the application of Rev. Rul. 76-358, page 291, this Bulletin, to a situation where a New York decedent's will contains a bequest to charity, in the circumstances described below.

In Rev. Rul. 76-358, it was concluded that New York law required apportionment of Federal and New York estate taxes *within* the residue of a decedent's probate estate where the decedent's will contained a direction to pay all such taxes "from my residuary estate" without any clear, unambiguous direction not to apportion taxes within the residue against those interests in the residue that gave rise to such taxes.

In the present case, all of the facts are the same as those in Rev. Rul. 76-358, except Item II of the decedent's will is as follows:

> All estate, inheritance, transfer, succession and other taxes of any nature which may be assessed or levied upon any property, whether or not passing under the Will, that may be payable because of my death in respect to the property constituting my gross estate for tax purposes, together with any interest and penalties thereon, shall be paid out of my residuary estate as an expense of administration, and no part of said taxes shall be apportioned or prorated to any beneficiary, legatee or devisee under this Will, or to any beneficiary or recipient of any property not passing under this Will.

The above-quoted tax payment clause is clear and unambiguous in its requirement that no apportionment of taxes be made. Unlike the simple direction to pay all taxes out of the residue, dealt with in Rev. Rul. 76-358, the present case involves an express requirement that no part of the estate taxes on any property that is included in the decedent's gross estate be apportioned to any beneficiary. *Compare Will of Shubert*, 10 N.Y. 2d 461, 225 N.Y.S. 2d 13, 180 N.E. 2d 410 (1962). Therefore, the rule set forth in Rev. Rul. 76-358, requiring apportionment of taxes within the residue of the estate, is not applicable here.

Accordingly, the amount allowable, in the present case, as a charitable deduction under section 2055 of the Code is $98,495.79, for which the computation results are provided below.

1. Charitable deduction.		
Gross estate		$550,000.00
Less: (a) Debts, expenses	$ 50,000.00	
(b) Bequest to *E*	200,000.00	
(c) Fed. tax (total)	88,133.21	
(d) N.Y. tax (total)	14,875.21	353,008.42
Net residue after taxes		$196,991.58
Times: Proportion passing to charity		×.50
Charitable deduction amount		$ 98,495.79
2. Federal estate tax.		
Gross estate		$550,000.00
Less: (a) Debts, expenses deductions	$ 50,000.00	
(b) Charitable deduction	98,495.79	
(c) Exemption	60,000.00	208,495.79
Federal taxable estate		$341,504.21
Federal tax thereon (after full credit for State death tax)		$ 88,133.21
3. New York estate tax.		
Federal taxable estate		$341,504.21
Plus: Fed. exemption (not allowed by N.Y.)		60,000.00
New York taxable estate		$401,504.21
Gross N.Y. tax thereon (before exemption-credits)		$ 15,075.21
Less: Exemption-credits re: bequests to 2 children of decedent		200.00
Net New York tax		$ 14,875.21

The above solution is the product of an interrelated computation of the charitable deduction, Federal tax, and New York tax, based on the methods described in the Supplemental Instructions for the Federal Estate Tax Return (Form 706). Note that the amounts subtracted from the gross estate in (1), above, with respect to Federal and New York taxes are the total tax liabilities, since all taxes are payable out of the residue without apportionment even within the residue. As a result, the interest of charity in 50% of the residue is burdened with a portion of the taxes generated by the other half of the residue (nondeductible), in addition to its being burdened with part of the taxes attributable to the pre-residuary bequest.

Section 2056.—Bequests, Etc., to Surviving Spouse

26 CFR 20.2056(b)-1: Marital deduction; limitations in case of life estate or other "terminable interest."

Marital deduction; terminable interest in annuity. No marital deduction is allowable under section 2056 of the Code for the value of annuity payments to the surviving spouse of a deceased employee, who is also survived by a dependent child, from a city's nonqualified pension plan that provides that upon the death or prior remarriage of the spouse the annuity payments will be apportioned equally among the dependent children. However, the deduction is allowable if there are no dependent children at the time of the decedent's death.

Rev. Rul. 76-404

Advice has been requested whether, under the circumstances described below the value of certain annuity payments under a Pension and Relief Fund passing to the decedent's surviving spouse and included in the decedent's gross estate fails to qualify for the marital deduction under section 2056 of the Internal Revenue Code of 1954 because the surviving spouse's interest is a terminable interest in property.

The decedent, employed by City *X*, was a participant in a "Pension and Relief Fund" at the time of death. The Fund provides retirement benefits for specified employees. In addition, upon the death of a participant employee, the employee's surviving spouse is entitled to specified monthly annuity payments until death or prior remarriage; and each dependent child under the age of 21 is entitled to specified monthly annuity payments. Upon the death or prior remarriage of the surviving spouse, the surviving spouse's annuity payments will be apportioned equally among the dependent children who are then under the age of 21.

Under the terms of the Pension and Relief Fund, each employee contributes three percent of the employee's salary to the Fund. Additional funds are contributed by City *X*, the employer, on behalf of the employees. The Pension and Relief Fund is not a qualified retirement plan under section 401(a) of the Code.

At the date of death, the decedent was survived by a spouse (aged 45 years) and a dependent child (aged 20½ years). The value of the annuity payments receivable by the surviving spouse and the child was included in the value of the decedent's gross estate under section 2039(a) of the Code (relating to survivorship benefits).

Section 2056(a) of the Code provides that, for purposes of the estate tax, the value of the taxable estate, except as limited by subsections (b), (c), and (d), shall be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse, but only to the extent such interest is included in determining the value of the gross estate.

Section 2056 (b)(1) of the Code provides that no marital deduction is

allowed with respect to certain interests in property, referred to generally as "terminable interests," passing from a decedent to the decedent's surviving spouse if (A) an interest in the property passes or has passed, for less than an adequate and full consideration in money or money's worth, from the decedent to any person other than the surviving spouse or the estate of such spouse, and (B) by reason of the passing, the other person may possess or enjoy any part of the property after the termination or failure of the spouse's interest.

Section 20.2056(b)-1(b) of the Estate Tax Regulations defines "terminable interest" to include annuities and similar interests that terminate with the passage of time. However, under section 20.2056(b)-1(a),(b), and (c) of the regulations, terminable annuities are nondeductible *only* if an interest in the annuity also passed from the decedent to a person other than the surviving spouse or the spouse's estate for less than an adequate consideration in money or money's worth, and if such interest may be enjoyed by such other person after the spouse's interest ceases. The deductibility of terminable annuities is illustrated in Example (3) of section 20.2056(b)-1 (g) of the regulations, which states:

> H during his lifetime purchased an annuity contract providing for payments to himself for life and then to W for life if she should survive him. Upon the death of the survivor of H and W, the excess, if any, of the cost of the contract over the annuity payments theretofore made was to be refunded to A. The interest which passed from H to W is a nondeductible interest since A may possess or enjoy a part of the property following the termination of the interest of W. If, however, the contract provided for no refund upon the death of the survivor of H and W, or provided that any refund was to go to the estate of the survivor, then the interest which passed from H to W is (to the extent it is included in H's gross estate) a deductible interest.

The Senate Finance Committee Report, *S. Rep. No. 1013 (Part 2)*, 80th Cong., 2d Sess. 7 (1948), illustrating applications of the terminable interest rule, provides as follows:

> *Example* (2). The decedent during his lifetime purchased an annuity contract under which the annuity was payable during his life and then to his spouse during her life if she survived him. The value of the interest of the decedent's surviving spouse in such contract at the death of the decedent is included in determining the value of his gross estate. A marital deduction is allowed with respect to the value of such interest so passing to the decedent's surviving spouse inasmuch as no other person has an interest in the contract. If upon the death of the surviving spouse the annuity payments were to continue for a term to her estate, or the undistributed portion thereof was to be paid to her estate, the deduction is nevertheless allowable with respect to such entire interest. *If, however, upon the death of the surviving spouse, the payments are to continue to another person (not through her estate) or the undistributed fund is to be paid to such other person, no marital deduction is allowable inasmuch as an interest passed from the decedent to such other person.* (Emphasis added.)

The above example is substantively indistinguishable from the facts of the instant case. The legislative history clearly indicates that the marital deduction is not allowable in the case of an annuity payable to a surviving spouse for life if the possibility exists that upon the death of the surviving spouse the spouse's payments are to continue to another person (not through the spouse's estate), or that the undistributed fund, that is the source of the spouse's payments, is to be paid to such other person. See Rev. Rul. 64-310, 1964-2 C.B. 342.

Accordingly, since in the instant case the surviving spouse's monthly annuity payments are to be apportioned among the decedent's dependent children who are under the age of 21 at the time of the spouse's death or prior remarriage, the value of the annuity payments passing to the surviving spouse fails to qualify for the marital deduction under section 2056 (b)(1) of the Code.

Further, if there are no dependent children under the age of 21 at the time of the decedent's death, the value of the annuity payments passing to the decedent's surviving spouse will qualify for the marital deduction inasmuch as no other person has an interest in the annuity payments after the death of the surviving spouse.

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26 CFR 20.2056(b)-5: Marital deduction; life estate with power of appointment in surviving spouse.

Marital deduction; life estate with power of appointment. A marital deduction is not allowable with respect to a testamentary trust that provides for payment of trust income to the surviving spouse quarterly until death, a power of appointment conferred on the surviving spouse, and retention of the assets in trust for two years after the death of the surviving spouse.

Rev. Rul. 76-446

Advice has been requested as to whether the testamentary trust described below provides a decedent's surviving spouse with a life estate and power of appointment described in section 2056(b)(5) of the Internal Revenue Code of 1954.

The decedent's will provided for the creation of a trust for the benefit of the decedent's surviving spouse. Under the terms of the trust, all trust income is to be paid to the surviving spouse at the end of each quarter. Income payments are to continue until the death of the spouse. Following the death of the spouse, trust income is to be accumulated and added to principal for two years. At the end of the two year period, the trust will terminate and all assets will be paid to the persons designated in the spouse's will. The testamentary power of appointment conferred upon the surviving spouse is exercisable, under the terms of the trust, in favor of anyone, including the estate of the surviving spouse.

The decedent's will designates the children of the decedent as the recipients of trust assets at termination in the event that the surviving spouse does not exercise the power of appointment.

The question presented is whether or not the "marital deduction trust" described above meets the requirements of section 2056(b)(5) of the Code, in view of the decedent's imposition of a two year delay between the surviving spouse's exercise of the power of appointment and the payment of trust assets to the appointees.

Section 2056(a) of the Code provides for a marital deduction with respect to property passing to a decedent's surviving spouse. Section 2056(b)(1) contains, however, a general rule that certain terminable interests as defined in that section that pass to a surviving spouse cannot qualify for the marital deduction. Under certain exceptions to the terminable interest rule, a marital deduction may nevertheless be allowable with respect to a terminable interest passing to a surviving spouse. One of those exceptions is set forth in section 2056(b)(5) as follows:

LIFE ESTATE WITH POWER OF APPOINTMENT IN SURVIVING SPOUSE.—In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse—

(A) the interest or such portion thereof so passing shall, for purposes of subsection (a), be considered as passing to the surviving spouse, and

(B) no part of the interest so passing shall, for purposes of paragraph (1)(A), be considered as passing to any person other than the surviving spouse.

This paragraph shall apply only if such power in the surviving spouse to appoint the entire interest, or such specific portion thereof, whether exercisable by will or during life, is exercisable by such spouse alone and in all events.

Section 20.2056(b)-5(g) of the Estate Tax Regulations contains the following provisions with respect to the power of appointment required by section 2056(b)(5) of the Code:

Power of appointment in surviving spouse.

(1) * * *.

(2) The power of the surviving spouse must be a power to appoint the entire interest or a specific portion of it as unqualified owner (and free of the trust if a trust is involved, or free of the joint tenancy if a joint tenancy is involved) or to appoint the entire interest or a specific portion of it as a part of her estate (and free of the trust if a trust is involved), that is, in effect, to dispose of it to whomsoever she pleases. * * *. An interest passing in trust will not be regarded as failing to satisfy the condition merely because takers in default of the surviving spouse's exercise of the power are designated by the decedent. The decedent may provide that, in default of exercise of the power, the trust shall continue for an additional period.

(3) * * *.

(4) The power in the surviving spouse is exercisable in all events only if it exists immediately following the decedent's death. For example, if the power given to the surviving spouse is exercisable during life, but cannot be effectively exercised before distribution of the assets by the executor, the power is not exercisable in all events. Similarly, if the power is exercisable by will, but cannot be effectively exercised in the event the surviving spouse dies before distribution of the assets by the executor, the power is not exercisable in all events. However, an interest will not be disqualified by the mere fact that, in the event the power is exercised during administration of the estate, distribution of the property to the appointee will be delayed for the period of administration. If the power is in existence at all times following the decedent's death, limitations of a formal nature will not disqualify an interest. Examples of formal limitations on a power exercisable during life are requirements that an exercise must be in a particular form, that it must be filed with a trustee during the spouse's life, that reasonable notice must be given, or that reasonable intervals must elapse between successive partial exercises. Examples of formal limitations on a power exercisable by will are that it must be exercised by a will executed by the surviving spouse after the decedent's death or that exercise must be by specific reference to the power.

It is apparent that section 2056(b)(5) of the Code requires that total control over the property passing from the decedent be conveyed to the surviving spouse. No other person may be designated to receive income from the property (with respect to which a deduction is allowable) while the spouse lives. No other person may be designated by the decedent as having any power over the disposition of such property, even with the spouse's consent. The only acceptable diminution of the spouse's control is that the spouse may be permitted to dispose of the property only at death, rather than at an earlier point in time, in view of the statutory description of the spouse's power of appointment as being acceptable only if the power "whether exercisable by will or during life, is exercisable by such spouse alone and in all events."

The above-quoted portions of section 20.2056(b)-5(g) of the regulations indicate the absolute control that the surviving spouse must receive through the power of appointment. It is only where the decedent has provided for *takers in default* of the spouse's exercise of an otherwise acceptable power of appointment that the regulations permit the imposition of a requirement that the property continue in trust beyond the spouse's lifetime. See the last sentence of section 20.2056(b)-5(g)(2), quoted above.

With respect to delays between the exercise of the spouse's power and distribution to the appointee of the property, that may occur either before or after the death of the surviving spouse, section 20.2056(b)-5(g)(4) of the regulations (quoted above) provides for only two situations that are stated not to be violative of the requirement that the power be exercisable in all events. In the first situation, a power that is *effectively* exercisable before administration of the decedent's estate is completed (that is, a power that fixes the rights of the appointees at the time of exercise) does not fail to be a power exercisable in all events merely because the appointees must await distribution upon completion of the administration of the estate.

In the second situation, a formal limitation requiring reasonable notice of the exercise of a power will not disqualify the spouse's interest.

In the present case, the *decedent* imposed the delay between exercise of the spouse's power and payment to the appointees. This *decedent*-imposed delay is distinguishable from the two situations in the regulations involving the difficulties of administration of decedents' estates and formal limitations in connection with the exercise of a power of appointment. Therefore, the exception in section 20.2056(b)-5 (g)(4) of the regulations for delays in distribution to appointees pending completion of estate administration cannot be applied to the delay imposed in the present case.

Accordingly, the interest of the surviving spouse in the trust created by the decedent in the present case does not meet the requirements of section 2056(b)(5) of the Code because the trustee is required to retain assets in trust for two years beyond the date on which the surviving spouse may exercise the power of appointment. As a result, no marital deduction is allowable under section 2056 with respect to the interest of the decedent's spouse in the trust.

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26 CFR 20.2056(b)-5: Marital deduction; life estate with power of appointment in surviving spouse.

Whether a testamentary trust in which the surviving spouse has a life estate and a power to appoint the trust corpus is a general power of appointment under Maryland law and, thus, qualifies for the marital deduction under the circumstances described. See Rev. Rul. 76-502, page 273.

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26 CFR 20.2056(c)-2: Marital deduction in cases involving community property.

Marital deduction; community and separate property. The adjusted gross estate, in cases involving community property, is determined by subtracting from the value of the entire gross estate the sum of all community property and an amount that bears the same ratio to the aggregate of the deductions allowed under sections 2053 and 2054 of the Code, irrespective of specific characterization, that the value of all of the noncommunity property bears to the entire gross estate.

Rev. Rul. 76-349

Advice has been requested as to the determination of the adjusted gross estate under section 2056 of the Internal Revenue Code of 1954, under the circumstances described below.

The decedent died on May 7, 1974. The value of the decedent's gross estate is $1,000,000 including separate property in the sum of $400,000 and a one-half share of community property valued at $600,000. The aggregate amount of the allowable deductions for administration expenses, debts, taxes, and losses is $300,000, of which $25,000 is attributable to separate property, $175,000 is attributable to community property and, $100,000 is attributable to both community and separate property. The decedent died testate and, by the terms of the will, the decedent's surviving spouse was sole beneficiary of the entire estate.

Section 2056(c)(1) of the Code provides, in general, that the aggregate amount of the deductions allowed under this section (the marital deduction) shall not exceed 50 percent of the value of the adjusted gross estate. In cases involving community property, section 2056(c)(2)(B) provides that the adjusted gross estate is determined by subtracting from the entire value of the gross estate the sum of: (i) the value of the community property held by the decedent at the time of death; (ii) the value of community property transferred by the decedent during decedent's life; (iii) proceeds of insurance policies on the life of the decedent to the extent purchased with community property; and (iv) an amount which bears the same ratio to the aggregate of the deductions allowed under sections 2053 and 2054 that the value of the property included in the gross estate, diminished by the amount subtracted under clauses (i), (ii), and (iii), bears to the entire value of the gross estate.

Example (1) of section 20.2056(c)-2(j) of the Estate Tax Regulations illustrates the application of section 2056(c)(2)(B) as follows:

The value of a decedent's gross estate is $300,000, of which $200,000 represents his separate property and $100,000 represents his one-half interest in community property. The decedent's separate property was inherited from his father. The deductions allowed under sections 2053 and 2054 total $45,000. The adjusted gross estate is computed as follows:

Value of gross estate	$300,000
Reduction under paragraph (a)(1)	100,000
Reduction under paragraph (a)(4) $\left\{\frac{\$200,000}{\$300,000} \times \$45,000\right\}$	30,000
Total reduction	130,000
Adjusted gross estate	170,000

The marital deduction will be $85,000 (one-half the value of the adjusted gross estate) in case the aggregate value of the deductible interests which passed from the decedent to his surviving spouse equals or exceeds that amount.

The question presented is whether the special rule under section 2056(c)(2)(B)(iv) of the Code is applicable solely to those deductions not clearly attributable either to community property or separate property (mixed) or whether it is applicable to all allowed deductions irrespective of the specific characterization of such deductions.

Neither the Code nor the regulation, cited above, require the deductions allowed under section 2053 and 2054 of the Code to be traced into, or otherwise identified as, separate or community property deductions for purposes of the computation of the adjusted gross estate in cases involving community property. The amount to be subtracted from the entire gross estate under section 2056(c)(2)(B)(iv) is explicitly described as "*** an amount which bears the same ratio to the *aggregate* of the deductions allowed under sections 2053 and 2054 ***."

The approach taken by the courts

to the various deduction provisions of the Code is that such provisions are a matter of "legislative grace" and, therefore, such provisions are subject to strict statutory construction. *Commissioner v. Sullivan,* 356 U.S. 27 (1958), 1958-1 C.B. 506; *Interstate Transit Lines v. Commissioner,* 319 U.S. 590 (1943), 1943 C.B. 1016.

Accordingly, the adjusted gross estate, in cases involving community property, shall be determined by subtracting from the entire value of the gross estate the sum of all community property and an amount that bears the same ratio to the *aggregate* of the deductions allowed under sections 2053 and 2054, *irrespective of specific characterization,* that the value of all of the noncommunity property bears to the entire gross estate.

The computation of the adjusted gross estate, in the instant case, is illustrated as follows:

Value of the gross estate		$1,000,000
Reduction under section 2056(c)(2)(B)(i)	$600,000	
Reduction under section 2056(c)(2)(B)(iv) $\frac{\$ 400,000}{\$1,000,000} \times \$300,000$	120,000	
Total reduction		720,000
Adjusted gross estate		$ 280,000

The marital deduction will be $140,000 (one-half the value of the adjusted gross estate).

Subchapter B.—Estates of Nonresidents not Citizens

Section 2106.—Taxable Estate

26 CFR 20.2106-1: Estates of nonresidents not citizens; taxable estate; deductions in general.

Whether deductions for charitable contributions for property transferred to a charitable remainder trust are allowable. See Rev. Rul. 76-307, page 56.

Chapter 12.—Gift Tax
Subchapter A.—Determination of Tax Liability

Section 2503.—Taxable Gifts

26 CFR 25.2503-3: Future interests in property.

Future interest; stock subject to transfer restrictions. Gifts of non-income-producing stock, received by the donor pursuant to a statutory merger and subject to a transfer restriction agreement prohibiting the stock from being offered, sold, pledged, or otherwise disposed of for a period of two years, does not transfer the immediate use, possession, or enjoyment to the donees and fails to qualify for either the gift tax annual exclusion or the annual exclusion with respect to an income interest.

Rev. Rul. 76-360

Advice has been requested whether the transfers of shares of stock from the donors to their children qualifies for the annual exclusion provided under section 2503(b) of the Internal Revenue Code of 1954 where a restrictive agreement prohibits the sale of the stock under the circumstances described below.

On September 5, 1975, the donors exchanged shares of common stock of *Y* company for shares of common stock of *Z* company, pursuant to a statutory merger of *Y* company into *Z* company. The shares received by the donors represented a minority interest in *Z* company. Also, on that date a stock transfer restriction agreement was executed pursuant to which the donors agreed that for two years thereafter they would not "offer, sell, pledge or otherwise transfer or dispose of any of the shares." This restriction, however, did not apply to the pledge of the shares to a specified trust company or gifts of the shares to relatives (spouse, children or grandchildren) provided such donees agreed to the restriction upon transfer of the shares and executed a substantially identical agreement.

On November 15, 1975, the donors gave by outright transfer 10*x* shares of *Z* company stock to each of their adult children, who executed the stock transfer restriction agreement as required by *Z* company. No dividends have been declared or paid with respect to *Z* company stock since either the donors or the donees acquired their interests and, according to a recent company prospectus, none are anticipated in the forseeable future.

Section 2503(b) of the Code provides that $3,000 may be excluded from the value of gifts made by a donor to any donee during the calendar year. This exclusion applies to all gifts other than gifts of future interests.

Section 25.2503-3 of the Gift Tax Regulations defines "future interests" to include reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time. Conversely, a present interest in property is defined as an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property.

For a gift to qualify for the annual exclusion, it is not enough that the donee receives a vested right to the property, even an interest that he can sell. *Kathrine Schuhmacher,* 8 T.C. 453 (1947), *acq.,* 1947-1 C.B. 4; *Rosa A. Howze,* 2 T.C. 1254 (1943). The statutory test is immediate right to use, possession or enjoyment. As the Supreme Court said in *Fondren v. Commissioner,* 324 U.S. 18, at 20 (1945), 1945-2 C.B. 421:

> It is not enough to bring the exclusion into force that the donee has vested rights. In addition he must have the right presently to use, possess or enjoy the property. These terms are not words of art, like "fee" in the law of seizen * * *, but connote the

right to substantial present economic benefit. The question is one of time, not when title vests, but when enjoyment begins. Whatever puts the barrier of a substantial period between the will of the beneficiary or donee now to enjoy what has been given him and that enjoyment makes the gift one of a future interest within the meaning of the regulations.

As was stated by the court in *French v. Commissioner,* 138 F.2d 254 (8th Cir. 1943): "Unless the donee is entitled unconditionally to the present use, possession, or enjoyment of the property transferred, the gift is one of a future interest for which no exclusion is allowed under the statute." Also, in *Commissioner v. Glos (Gloss)*, 123 F.2d 548, at 550 (7th Cir. 1941), it was noted that "the sole statutory distinction between present and future interests lies in the question of whether there is postponement of enjoyment of specific rights, powers or privileges which would be forthwith existent if the interest were present."

In the case of *Laura M. Hutchinson,* 47 T.C. 680 (1967), *nonacq.* on another issue, 1967-2 C.B. 4, the donor made gifts of stock to various donees in accordance with an "Agreement of Trust." The shares were registered in the names of the donees, subject only to a restriction against sale, transfer, or pledge for a ten-year period, coupled with delivery of the certificates to the trustee-bank. In holding that the gift tax annual exclusion was not applicable, the Tax Court explained at page 687:

> The ability of the donees herein to realize on the capital investment represented by the shares was severely circumscribed. Although they had the right to vote, their shares represented a distinct minority which could easily be outvoted. Absent a breach of fiduciary duty by the officers, directors, or other stockholders, if they were dissatisfied with the operations or profitability of the corporation or the prospective value of their shares, the normal recourse of the shareholder—namely, the right to dispose of his investment—was not open to them. * * * Thus, aside from the right to income, which respondent has allowed as a "present interest," or a showing of special circumstances, which would have justified an exercise of the power of discretionary distribution by the bank, the donees were locked into the capital investment for the specified term.

In the instant case, as in *Hutchinson,* the donees had no right or power to immediately reach the capital investment in the stock to any substantial degree because of the curtailment of their ownership rights. The donees' power to make gifts of the donated stock within a narrow class of relatives and their right to pledge the stock do not, either separately or together, afford the donees the "right to substantial present economic benefit" that is necessary to qualify the gifts as present interests. See *Fondren,* above. The limited special power to make gifts falls short of the unconditional use, possession or enjoyment contemplated by the courts in their implementation of the annual exclusion provisions of section 2503(b) of the Code. With respect to the right to pledge the stock for a loan, the court in *Welch v. Paine,* 120 F.2d 141 (1st Cir. 1941), in concluding that a gift of a vested remainder interest after a life estate was a gift of a future interest, noted that the "availability of an interest for the satisfaction of claims of creditors is not inconsistent with its being a 'future interest.'" See also *Howze,* above.

In view of the foregoing, it is concluded that the donees did not have the immediate use, possession or enjoyment of the transferred stock required under section 2503(b) of the Code. Accordingly, the transfers do not qualify for the gift tax annual exclusion.

Further, since no dividends have been declared or paid since the donors or the donees acquired their interests, and since none are anticipated in the foreseeable future, no annual exclusion is allowable with respect to an income interest in the transferred stock.

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26 CFR 25.2503-3: Future interests in property.

Whether premium payments made by an employer for group term life insurance issued on the life of an employee, where the employee irrevocably assigned the policy to a trust, are indirect transfers by the employee to the assignee of the policy for purposes of section 2511 of the Code, and if so, whether such gifts qualify for the annual $3,000 exclusion. See Rev. Rul. 76-490, page 300.

Subchapter B.—Transfers

Section 2511.—Transfers In General

26 CFR 25.2511-1: Transfers in general.

Remainder interest in trust; value not ascertainable. A trust provision that gives the trustee the absolute discretion to allocate all of the proceeds from the sale of any minerals to income, applicable state law providing that a portion be considered principal, renders a donor's retained interest incapable of valuation and the entire value of the property transferred in trust is subject to the gift tax.

Rev. Rul. 76-275

Advice has been requested whether, under section 2511 of the Internal Revenue Code of 1954, the entire value of property transferred in trust is subject to the gift tax under the circumstances described below.

A donor created a trust, the governing instrument of which provides that all the net income is to be distributed to *A* and *B* during their joint lives and to the survivor of them for life. Thereafter, the trustee, in its discretion, may accumulate the net income or distribute it to either *C* or *D*, or both of them, for purposes such as the education, comfort and welfare of *C* and *D*.

The trust is to terminate, and the principal of the trust will revert to the donor or the donor's estate, at the last to occur of (1) the expiration of ten years and one day; (2) the death of *A*; or (3) the death of *B*.

The governing trust instrument requires the trustee to distribute all of the net trust income to *A* and *B*.

However, the instrument gives the trustee the full and complete power, as if it were the sole and absolute owner, to invest, reinvest, and change the form of the principal into oil, gas and other mineral royalties, overriding royalties, and production payments. All proceeds from the sale, lease or development of oil, gas or other minerals accruing to the trust, whether as bonuses, royalties, overriding royalties, production payments or from operating interests, may be considered as income and the trustee is not required to apportion 27½ percent, or any percentage, of the gross proceeds therefrom to the principal of the trust. Under the applicable state law, 27½ percent of all receipts from oil and gas interests are considered to be principal and not income.

Section 2501 of the Code imposes a tax on the transfer of property by gift during a calendar quarter by any individual. Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(e) of the Gift Tax Regulations provides that:

> If a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred. * * * However, if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift. * * *

Under the above regulation, where a donor's retained interest is severable from the transferred interest, the value of the retained interest may be ascertained by multiplying the transferred property by the appropriate actuarial factor. The present worth so determined is not subject to the gift tax.

However, if a governing trust instrument provides that payments representing a normal part of trust principal shall (or, in the trustee's discretion, may) be treated as income and paid to an income beneficiary, then the donor's retained interest is not severable from the gift portion of the transferred property since no known formula has been advanced for ascertaining the value of the retained interest. Compare Rev. Rul. 60-385, 1960-2 C.B. 77, where it is held that no charitable deduction is allowable, for Federal income, estate or gift tax purposes, if a trust instrument provides that dividends representing capital gains may be distributed as income to the life tenant instead of being held as part of principal for the benefit of the charitable remainderman.

In the instant case, the governing trust instrument gives the trustee the duty to distribute all of the income of the trust; the power to change the form of the assets of the trust to assets that can be sold to produce income; and the absolute discretion to allocate all of the proceeds of the sale of any minerals to income and none to principal. The effect of these powers is to give the trustee the ability to distribute the entire principal of the trust as income. This renders the donor's retained interest in the trust contingent upon the trustee's discretionary exercise of the powers and, thus, makes it incapable of valuation on the basis of generally accepted valuation principles.

Accordingly, the entire value of the property transferred in trust is subject to the gift tax under section 2511 of the Code.

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26 CFR 25.2511-1: Transfers in general. (Also Section 2503; 25.2503-3.)

Insurance policy transferred to irrevocable trust; employer's plan. Life insurance premiums voluntarily paid by an employer with respect to a group term policy held by an irrevocable trust created by an employee are subject to tax as indirect transfers by the employee and qualify as a gift of a present interest for purposes of the annual $3,000 exclusion.

Rev. Rul. 76-490

Advice has been requested whether certain life insurance premiums paid by an employer with respect to a group term policy held by a trust created by an employee are subject to the gift tax under section 2501 of the Internal Revenue Code of 1954 as indirect transfers under section 2511 of the Code, under the circumstances described below, and if so whether the gift is a gift of a present interest that qualifies for the annual exclusion under section 2503(b).

In 1970, *X* Company entered into an agreement with an insurance company providing for a master group term insurance policy insuring the lives of its employees. Only an employee was entitled to be insured. By the terms of the insurance contract, premiums were to be paid monthly in advance, on the first day of each month, by *X* Company. On January 31, 1975, *D*, an employee of *X* Company, created an irrevocable trust and assigned thereto all right, title and interest in a group term life insurance policy on *D*'s life issued pursuant to the master policy. Under the terms of the trust, the beneficiary or the beneficiary's estate was to receive the full proceeds of the policy immediately on *D*'s death.

The policy assigned to the trust provided insurance coverage in an amount of 200*x* dollars until *D* reached age 65, or ceased employment with *X* Company, whichever occurred first. Neither *D* nor the trust had a contractual right to require *X* Company to maintain the group contract. The premiums paid by *X* Company with respect to *D*'s group insurance coverage were not reported as gifts by *D* in 1975. *D* did not report such sums as gifts because of *D*'s belief that, by reason of the assignment, *X* Company paid the premiums for the direct benefit of the trust beneficiary.

Section 2501 of the Code imposes a tax on the transfer of property by gift during a calendar quarter by any individual. Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(c) of the Gift Tax Regulations provides that:

> * * * all transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed, constitute gifts subject to tax.

Section 25.2511-2(b) of the regulations provides, in part, as follows:

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete.

Section 25.2511-1(h)(8) of the regulations provides, in part, as follows:

> If the insured purchases a life insurance policy, or pays a premium on a previously issued policy, the proceeds of which are payable to a beneficiary or beneficiaries other than his estate, and with respect to which the insured retains no reversionary interest in himself or his estate and no power to revest the economic benefits in himself or his estate or to change the beneficiaries or their proportionate benefits (or if the insured relinquishes by assignment, by designation of a new beneficiary or otherwise, every such power that was retained in a previously issued policy), the insured has made a gift of the value of the policy, or to the extent of the premium paid, even though the right of the assignee or beneficiary to receive the benefits is conditioned upon his surviving the insured. * * *

Section 2503(b) of the Code permits the exclusion of $3,000 of gifts made to any one donee during the calendar quarter (except gifts of future interests in property), less the aggregate of the amount of such gifts to such person during all preceding calendar quarters of the calendar year, in determining the total amount of gifts for the calendar quarter. The entire value of any gift of a future interest must be included in the total amount of gifts for the calendar quarter in which the gift is made.

Section 25.2503-3(a) of the regulations provides, in part, as follows:

> "Future interests" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note * * * or in a *policy of insurance*, the obligations of which are to be discharged by payments in the future. (Emphasis added.)

Section 25.2503-3(c), Example (6) of the regulations, provides:

> *L* pays premiums on a policy of insurance on his life. All the incidents of ownership in the policy (including the right to surrender the policy) are vested in *M*. The payment of premiums by *L* constitutes a gift of a present interest in property.

The interest in the group policy that the employee assigned to the irrevocable trust had no ascertainable value at the time it was transferred since the employer could have simply failed to make further premium payments. Therefore, no taxable gift occurred.

As to the payment of the premiums by the employer, it is well established for purposes of various estate tax provisions that, in an appropriate case, a transfer by an employee can take place where, in consideration of an employee's past and future services, the employer promises to pay a survivor's benefit. *Estate of Bogley v. United States,* 514 F. 2d 1027 (Ct. Cl. 1975); *Estate of Tully, Sr. v. United States,* 528 F. 2d 1401 (Ct. Cl. 1976); *Estate of Fried,* 54 T.C. 805 (1970), *aff'd,* 445 F. 2d 979 (2d. Cir. 1971), *cert denied,* 404 U.S. 1016 (1972). Compare Rev. Rul. 76-304, page 269, this Bulletin. Of course, the exact timing of when the transfer takes place would depend on all the facts and circumstances. Although the case under consideration involves the gift tax, rather than the estate tax, the provisions dealing with both taxes should, if possible, be interpreted *in pari materia, Sanford v. Commissioner,* 308 U.S. 39 (1939), 1939-2 C.B. 340.

Each time a premium was paid by *X* Company additional compensation was conferred on *D*. By irrevocably assigning the insurance policy to the trust and continuing participation in the group term life insurance contract, *D* caused the economic benefit of this additional compensation to inure to the assignee as each payment was made.

Accordingly, in the instant case, each premium payment made by the employer for group term life insurance on the life of *D*, where *D* irrevocably assigned the policy to the trust, is deemed an indirect transfer by *D* to the assignee of the policy for purposes of section 2511 of the Code, and subject to the gift tax imposed by section 2501.

In addition, the payment of each monthly premium for the group term life insurance is not a gift of a future interest in property and, therefore, qualifies for the $3,000 annual exclusion provided by section 2503(b) of the Code.

Section 2512.—Valuation of Gifts

26 CFR 25.2512-2: Stocks and bonds.

Use of composite listing of transactions on the combined exchanges to evaluate stocks and bonds when records of the principal exchange are not available. See T.D. 7432, page 264.

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26 CFR 25.2512-8: Transfers for insufficient consideration.

Property conveyed to trust in exchange for annuity. An annuity to be paid exclusively from the assets of a trust, which may be distributed at any time through the exercise of the trust beneficiary's power of appointment, has no fair market value and the entire value of property transferred by the donor to the trust in exchange for the promise

of the annuity is a gift for gift tax purposes.

Rev. Rul. 76-491

Advice has been requested as to the value of an annuity payable from trust assets to the transferor of property to a trust in the situation described below.

In November 1975, the donor created an irrevocable inter vivos trust under the terms of which the trustee is to accumulate income and add it to trust principal during the life of the donor's adult child. The child is empowered to appoint trust income and principal to any relative of the donor other than the child in such amounts as the child sees fit. The child may exercise the power of appointment at any time during life or at death. In default of exercise of the power of appointment, any trust assets that remain at the child's death shall be distributed among the child's descendants. The trustee is empowered to invest trust property in any type of asset in any fashion, and upon such terms as the trustee deems proper in its sole and uncontrolled discretion.

As of May 12, 1976, the trust corpus was worth $300,000. On that date, which was the donor's fifty-third birthday, the donor and the trustee executed an agreement under which the trustee promised, on behalf of the trust, to pay $800 at the end of each month to the donor for the donor's life. In exchange, the donor transferred $105,711.21 to the trust. Under the agreement, the donor may look only to the trust assets for payment of the annuity. The trustee is relieved of any liability in the event that the trust assets are not sufficient for making the annuity payments.

Under Table A(1) and subsection (b)(2) of section 25.2512-9 of the Gift Tax Regulations, the present value of the right to receive an annuity of $800 at the end of each month for the life of a male aged 53 years is $105,711.21, which is precisely the value of the property transferred by the donor to the trust in exchange for the annuity.

The question presented is whether the donor received full and adequate consideration in money or money's worth for the transfer to the trust in exchange for the annuity.

Section 2512(b) of the Internal Revenue Code of 1954 provides as follows:

> Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar quarter.

Under section 25.2512-9 of the regulations, the various tables contained therein provide factors that can be used to determine the present value of annuities, life estates, and certain other types of interests that depend on the life of one person or on a term of years.

In the present case, the donor must rely on the trust assets as the only source for the annuity payments. Under the terms of the trust, however, the entire property of the trust may be distributed through the exercise of the adult child's power of appointment, thus terminating the trust and extinguishing any further opportunity for the donor to receive the annuity payments. Therefore, it is not possible to predict whether any annuity payment would actually be made from the trust. Because of this uncertainty as to payment, the valuation method set forth in section 25.2512-9 of the regulations is not applicable.

A "right" to an annuity that may be extinguished at any time, by the exercise of a power of appointment over the fund that is the only source for the annuity payments, possesses no fair market value. See section 25.2512-1 of the regulations.

In the present case, since the promised annuity has no value, it is not "consideration in money or money's worth." Accordingly, the entire value of the property transferred by the donor to the trust in exchange for the promise of an annuity is a gift for Federal gift tax purposes.

Section 2514.—Powers of Appointment

26 CFR 25.2514-1: Transfer under power of appointment.

Release of power of appointment; Washington State. The release by the trustee-income beneficiary of the power to consume, invade or appropriate the corpus of a testamentary trust for the beneficiary's health, care, maintenance, and enjoyment is, under the law of the State of Washington, the exercise of a general power of appointment and is a transfer of property for gift tax purposes.

Rev. Rul. 76-547

Advice has been requested as to the applicability of section 2514 of the Internal Revenue Code of 1954 in the situation described below.

A's parent died testate in 1960 and created a testamentary trust under the terms of which the trust income was payable to *A* for life. *A*, as designated trustee, was given the following power over the corpus of the trust.

> In the event the net income is inadequate for *A*'s care, maintenance, health and *enjoyment*, and the care, maintenance, health and *enjoyment* of any member of *A*'s family then dependent upon *A*, the trustee is authorized to distribute such portions of the principal of said trust as, in the discretion of the trustee, may be required for such purposes, taking into consideration other income or assets available to *A*. In making such application, it is the trustor's desire that *A* and members of *A*'s family continue to live in their accustomed standard within the limitation of funds available and it is his desire that said trustee resolve in *A*'s favor any uncertainty concerning distributions from the principal.

In 1976, without ever having invaded the corpus of the trust, *A* executed an instrument which read as follows: "I hereby forever release any right which I possess to distribute the principal of the trust estate for any

purpose." Both *A* and *A*'s parents were lifelong residents of the State of Washington.

The question presented is whether the power granted to *A* to consume, invade or appropriate the trust corpus for the care, maintenance, health, and *enjoyment* of *A* is a general power of appointment, the release of which shall be deemed a transfer of property by *A* under section 2514 of the Code. (Because of the sixteen year time span between the date the power in question was created and the date it was surrendered, there is no issue as to whether *A* effectively "disclaimed" or "renounced" the power.)

Section 2514(b) of the Code provides that "The exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power. A disclaimer or renunciation of such a power of appointment shall not be deemed a release of such power."

For Federal gift tax purposes, section 2514(c) of the Code defines a "general power of appointment" as a power which is exercisable in favor of the individual possessing the power, the individual's estate, the individual's creditors, or the creditors of the individual's estate. Section 2514(c)(1) provides that a power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor shall not be deemed a general power of appointment. Similarly, for Federal estate tax purposes, section 2041(b)(1)(A) defines a power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.

Under section 25.2514-1(c)(2) of the Gift Tax Regulations, defining powers limited by an ascertainable standard, it is provided that a power to consume, invade, or appropriate income or corpus, or both, for the benefit of the possessor is limited by such a standard if the extent of the possessor's duty to exercise and not to exercise the power is reasonably measurable in terms of the possessor's needs for health, education, or support (or any combination of them). For example, a power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Section 25.2514-1(c)(2) further provides that in determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust the beneficiary's other income before the power can be exercised.

While legal rights and interests in property (such as the creation and the breadth of a power to appropriate or consume the principal of a trust) is a matter of state law, it is the Federal law that designates what rights or interests so created shall be taxed. *United States* v. *Pelzer,* 312 U.S. 399 (1941), 1941-1 C.B. 441; *Morgan* v. *Commissioner,* 309 U.S. 78 (1940), 1940-1 C.B. 229. Thus, in determining whether *A*'s power to consume, invade, or appropriate the trust corpus, for the benefit of *A* is limited by an ascertainable standard, the initial step is to ascertain the scope of *A*'s rights under applicable state law.

While a review of Washington State law reveals no statutory or case law authority directly on point as to whether the invasionary powers granted to *A* are limited by an ascertainable standard, the Supreme Court of Washington has stated that when construing an instrument's provisions, the intent of the donor or testator is paramount and must be gathered from the four corners of the instrument when read as a whole; and that the controlling intention is that which is positive and direct, and not merely negative or inferential. *In re Douglas' Estate,* 398 P. 2d 7 (1965); *In re Searl's Estate,* 186 P. 2d 913 (1947).

As noted previously, powers of appointment limited by an ascertainable standard are defined the same way in sections 2514(c)(1) and 2041(b)(1)(A) of the Code for purposes of the gift and estate tax. Thus, powers of appointment have the same meaning under both the gift and estate tax since the estate and gift tax are "in pari materia and must be construed together." *Sanford* v. *Commissioner,* 308 U.S. 39 (1939), 1939-2 C.B. 340.

In *Stafford* v. *U.S.,* 236 F. Supp. 132 (E.D. Wisc. 1964), the decedent was the income beneficiary of a testamentary trust established by decedent's predeceased spouse under Wisconsin law. Under the terms of the trust, the decedent had the right to use and enjoy the principal, as well as the income, in the event he had need thereof for his care, comfort or *enjoyment.* The case involved the necessary interpretation and application of the word "enjoyment", as in the instant case, in the context of the "ascertainable standard" exception in section 2041 of the Code. The court held that the decedent's power to invade principal was not limited by an ascertainable standard and stated at page 134:

> The word "enjoyment" indicates that the principal could be invaded for purposes other than health, education, support, and maintenance. That word connotes consolation, contentment, ease, happiness, pleasure and satisfaction. Black, Law Dictionary 623 (4th ed. 1951).
>
> A power to invade principal for those purposes, if limited at all, is not limited by an ascertainable standard relating to the health, education, support or maintenance of the person possessing such a power.

Here, as in *Stafford,* the language of the governing trust instrument giving *A* liberal discretion concerning distributions from the principal for *A*'s *enjoyment* is not sufficiently restrictive so as to indicate an intent by the testator that the power granted to *A* was to be limited by any "ascertainable standard" within the meaning of section 2514(c)(1) of the Code.

Further, the fact that *A* is to consider other available assets and income in the determination of whether the net income from the trust principal is adequate for *A*'s care, maintenance, health and enjoyment is not a sufficient limitation on the breadth of the granted power of appointment so as to fall within the exception of section 2514(c)(1) of the Code. As noted above, section 25.2514-1(c)(2) of the regulations specifically provides, in part: "In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised."

Moreover, *A*, as trustee, would not be prohibited by local law from exercising the expressly granted power to invade the trust principal for *A*'s enjoyment. The Supreme Court of Washington has held that where discretion is conferred upon a trustee with respect to carrying out the trust, the exercise thereof is not subject to control by the court except to prevent an abuse of such discretion. *Monroe* v. *Winn,* 133 P. 2d 952 (1943); *Peoples' National Bank of Washington in Seattle* v. *Jarvis,* 364 P. 2d 436 (1961); *Occidental Life Insurance Co. of California* v. *Blume,* 399 P. 2d 76 (1965). An invasion of the trust principal by *A* for the enjoyment of *A* would be fully consistent with the purpose and intent of the trust instrument and, thus, such invasion would not be subject to control by a court so as to limit an otherwise general power of appointment.

Thus, in the instant case, *A* was granted by the express terms of the governing instrument a general power of appointment exercisable in favor of *A*, *A*'s estate, *A*'s creditor's, or the creditors of *A*'s estate. Therefore, the release of the power by *A* is deemed a transfer of property for gift tax purposes under section 2514(b) of the Code.

Subchapter C.—Deductions

Section 2521.—Specific Exemption [Repealed by section 2001(b)(3) of Public Law 94-455, effective to gifts made after December 31, 1976.]

26 CFR 25.2521-1: Specific exemption. (Also Section 2523; 25.2523(a)-1)

Marital deduction; erroneous use of specific deduction in prior periods. A donor, who failed to claim the marital deduction allowable for gifts made in prior years, thereby exhausting the allowable specific exemption, may recover for use in the current year the portions of specific deductions actually claimed and equal to the amounts that should have been claimed as marital deductions.

Rev. Rul. 76-451

Advice has been requested whether any part of the Federal gift tax specific exemption of $30,000, provided under section 2521 of the Internal Revenue Code of 1954, is available to the donor in 1976 under the circumstances described below.

In 1961, the donor, *D*, made an outright gift to the donor's spouse, *S*, of property valued at $32,000. On the donor's Federal gift tax return, no marital deduction was claimed with respect to the outright gift to the spouse. However, the donor claimed an annual exclusion of $3,000 and a portion of the specific exemption in the amount of $29,000. Thus, no gift taxes were due in 1961.

In 1962, *D* made an outright gift to *S* of property valued at $10,000. On the donor's gift tax return, no marital deduction was claimed with respect to the outright gift to *S*. However, the donor claimed an annual exclusion of $3,000 and the remaining portion of the specific exemption in the amount of $1,000. The donor's computation resulted in a taxable gift of $6,000 on which a gift tax of $165 was paid.

On January 1, 1976, *D* made an outright gift to *S* of property valued at $38,000. At this time, on *D*'s Federal gift tax return, $19,000 was claimed as a marital deduction; $3,000 was claimed for the annual exclusion; and $16,000 was claimed as the *correct* remaining balance of *D*'s specific exemption on the basis that *D*'s failure to claim allowable marital deductions with respect to the 1961 and 1962 gifts to *S* restored that amount of the specific exemption that had been previously claimed.

Section 2501 of the Code imposes a tax on the transfer of property by gift during a calendar quarter by an individual. Under section 2503(b), the first $3,000 of gifts made to any one person during the calendar year (except gifts of future interests in property) is excluded in determining the total amount of gifts for the calendar quarter. A lifetime exemption of $30,000 is allowed under section 2521. At the option of the donor, the exemption may be taken in the full amount in a single taxable quarter (or year for gifts made prior to 1971) or it may be spread over a period of quarters (or years before 1971) in such amounts as the donor sees fit. No further exemption may be taken after the total amount of $30,000 has been used. Section 25.2521-1(a) of the Gift Tax Regulations.

Deductions are allowed under sections 2522 and 2523 of the Code, respectively, subject to certain limitations and conditions not here relevant, (1) for the value of property interests transferred by gift for public, charitable or religious uses; and (2) for one-half the value of any property interest transferred to a person who, at the time of the gift, was the donor's spouse.

The tax applies to the total taxable gifts. The amount of the taxable gifts is arrived at by deducting from the total amount of gifts during the calendar quarter (that is, gross gifts less applicable $3,000 exclusions), the specific

exemption and/or the charitable and marital deduction(s).

Section 2504, subsections (a) and (b), of the Code provides that in computing taxable gifts for preceding calendar years or quarters for the purpose of computing the tax for any calendar quarter, there shall be treated as gifts all transfers treated as gifts under the applicable gifts tax law in effect at the time of the transfer, including the law relating to exclusions from gifts, and there shall be allowed such deductions as were provided for under such laws, except that the specific exemption shall be limited to the amount provided for in section 2521 ($30,000). Consequently, to determine the correct gift tax liability for any calendar year or quarter it is necessary to ascertain the correct amount of the aggregate sum of the taxable gifts for each of the preceding calendar years or quarters, not necessarily that returned for those calendar years or quarters and in respect of which tax was paid. Section 25.2504-1 of the regulations.

Section 2504(c) of the Code provides that for purposes of computing the gift tax for any calendar quarter, if the time for the assessment of the gift tax has expired and if a gift tax has been assessed or paid for such preceding calendar year or quarter, then the value of the gift shall be limited to that value used in computing the gift tax for the last preceding calendar year or quarter for which a gift tax was assessed or paid. This rule does not apply to adjustments involving issues other than *valuation*. Section 25.2504-2 of the regulations. Therefore, if interpretations of the gift tax *law* in prior calendar years or quarters resulted in the erroneous inclusion of property for gift tax purposes that should have been excluded or the erroneous exclusion of property that should have been included, then adjustments must be made in order to arrive at the correct aggregate of taxable gifts for the preceding calendar years and/or quarters. Section 25.2504-1(d).

As was pointed out in *Commissioner v. Disston*, 325 U.S. 442 (1945), 1945 C.B. 421, the statutory plan for taxing the making of gifts requires the determination of the correct aggregate of net gifts for previous years in order to compute the gift tax for a given year. While assessment and collection of tax may not be made for a previous year which is barred by the statute of limitations, an examination may be made into events of prior closed years for the purpose of correctly determining gift tax liability for a year that is still open. See also *Kathrine Schuhmacher*, 8 T.C. 453 (1947), acq. 1947-1 C.B. 4, where in prior years the taxpayer erroneously reported gifts in excess of the value of the taxpayer's community interest in the transferred property and the entire amount of the taxpayer's specific exemption was applied against such gifts. The court held that in computing the tax for the present year the taxpayer was entitled to use the specific exemption in the amount of the exemption erroneously claimed in prior years.

Total specific exemption			$30,000
Less: (1) Portion actually claimed in 1961	$29,000		
Less allowable marital deduction ($32,000 x .5)	16,000		
Exemption deemed used (excess of marital deduction)		$13,000	
(2) Portion actually claimed in 1962		1,000*	14,000
Unused portion of exemption, available in 1976			$16,000

* Exemption claimed in 1962 did not exceed allowable marital deduction; therefore, amount actually claimed is amount deemed electively used by the donor.

In accordance with the above, the marital deduction not claimed by *D* in determining the amount of the taxable gifts for 1961 and 1962 would nonetheless be taken into account in determining the aggregate sum of the prior taxable gifts in order to determine the tax rate applicable to *D*'s 1976 gifts under section 2502(a) of the Code.

It also follows that *D* did not make an effective election in 1961 and 1962 to use the portions of the specific exemption *equal to* the amounts that should have been claimed as marital deductions. In this regard, compare *Carl J. Schmidlapp v. Commissioner*, 43 B.T.A. 829, *nonacq. on another issue*, 1942-1 C.B. 28, where it was held that the full amount of the specific exemption was available to a donor in a subsequent year where, in prior years, the donor failed to claim allowable annual exclusions, but instead applied a portion of the specific exemption. See also Rev. Rul. 55-709, 1955-2 C.B. 609.

Accordingly, $16,000 of the specific exemption is available to the donor *D* in 1976, computed as follows:

Section 2522.—Charitable and Similar Gifts

26 CFR 25.2522(a)-1: Charitable and similar gifts; citizens or residents.

Whether deductions for charitable contributions for property transferred to a charitable remainder trust are allowable. See Rev. Rul. 76-307, page 56.

26 CFR 25.2522(c)-3: Transfers not exclusively for charitable, etc., purposes in the case of gifts made after July 31, 1969.

Charitable remainder trust; charitable deduction. The deduction for a remainder interest transferred in trust to an organization described in sections 170(c), 2055(a), and 2522(a) of the Code is not disallowed under section 2522(c)(2) where the trustee has the power, exercisable during the donor's life, to add and/or substitute additional organizations described in section 170(b)(1)(A) as remaindermen.

Rev. Rul. 76-371

Advice has been requested whether a charitable deduction for a remainder interest in property is to be disallowed under section 2522(c)(2) of the Internal Revenue Code of 1954 under the circumstances described below.

On November 1, 1973, the donor transferred property in trust retaining a unitrust interest described in section 664(d)(2)(A) of the Code and section 1.664-3(a)(1)(i) of the Income Tax Regulations thereunder. The remainder interest in the property was transferred to an organization described in sections 170(c), 2055(a) and 2522(a) of the Code. The governing instrument of the trust, in general, complies with sections 1.664-1 and 1.664-3 of the regulations. However, the trustee was given the power, exercisable during the grantor's life, to add and/or substitute additional organizations described in section 170(b)(1)(A) as remaindermen.

The question presented is whether a deduction for the remainder interest transferred to an organization described in sections 170(c), 2055(a), and 2522(a) of the Code is to be disallowed under section 2522(c)(2) of the Code when a trustee has a power exercisable during the grantor's life to add or substitute as remaindermen organizations described in section 170(b)(1)(A) of the Code.

Section 2522(a) of the Code allows a Federal gift tax deduction for transfers to or for the use of a qualified charitable organization. Section 2522(c)(2) of the Code provides that where a remainder interest in property is transferred from the donor to a qualified charitable organization and an income interest in the same property is transferred to a noncharitable beneficiary no deduction is allowable under section 2522(a) for the remainder interest unless such interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664 of the Code) or a pooled income fund (described in section 642(c)(5) of the Code).

The regulations under section 664(d)(2) of the Code, relating to charitable remainder unitrusts, require that all charitable remaindermen of such trusts must be organizations described in section 170(c) of the Code. Section 1.664-3(a)(6)(i) of the Income Tax Regulations. If a Federal gift tax charitable deduction is sought, all charitable remaindermen of a charitable remainder unitrust must also be organizations described in section 2522(a) or (b) of the Code. Section 25.2522(c)-3(c)(2)(iv); Rev. Rul. 72-395, 1972-2 C.B. 340, 343.

The organizations specified in section 2522(a) of the Code, to which a transfer is deductible as a charitable transfer, include any organization described in section 170(b)(1)(A) of the Code. However, a Federal income tax deduction may be obtained for a transfer to a cemetery company under section 170(c)(5) of the Code, but no Federal gift tax deduction may be obtained for a transfer to such organization.

Thus, there is no possibility under the instrument that the remainder interest will be transferred to or for the use of an organization other than an organization described in section 2522(a) of the Code upon the death of the noncharitable life beneficiary by reason of the trustee's exercise of the granted power to add and/or substitute additional organizations described in section 170(b)(1)(A) of the Code.

Accordingly, a deduction for the remainder interest transferred in trust to an organization described in sections 170(c), 2055(a), and 2522(a) of the Code is not to be disallowed under section 2522(c)(2) of the Code where the trustee has the power exercisable during the grantor's life to add and/or substitute as remaindermen additional organizations described in section 170(b)(1)(A) of the Code.

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26 CFR 25.2522(c)-3: Transfers not exclusively for charitable, etc., purposes in the case of gifts made after July 31, 1969. (Also Section 170; 1.170A-12.)

Charitable remainder interest in personal residence; valuation. A charitable remainder interest in a personal residence donated to a church in 1976, subject to a 20-year term for a noncharitable tenant, is valued for gift tax purposes without taking into consideration the elements of depreciation for the period during which the property will be in the noncharitable tenant's possession. The value of the charitable remainder interest is higher for gift tax purposes than for income tax purposes.

Rev. Rul. 76-473

Advice has been requested whether, for Federal gift tax purposes, the method of evaluating a charitable remainder interest in real property should reflect an adjustment for future depreciation for the period during which the property will be in the possession of a noncharitable tenant for a term certain.

In 1976, *D* donated to *X* Church a remainder interest in *D*'s personal residence, consisting of a house and land, subject to a 20 year term for *A* or *A*'s estate should *A* die within 20 years. At the time of the donation, the house was worth $60,000 and had an expected useful life of 45 years, at the end of which time it is expected to be

worth $10,000. The land was worth $8,000 at the time of the donation.

In computing a donor's taxable gifts for the calendar quarter, section 2522 (a) of the Internal Revenue Code of 1954 authorizes a deduction for the amount of all gifts made during the quarter to or for the use of any corporation organized and operated exclusively for religious, charitable, etc., purposes.

Sections 201(a) and (d) of the Tax Reform Act of 1969 (Pub. L. 91-172, 1969-3 C.B. 10) added section 170 (f)(4) and amended sections 2055(e) and 2522(c) of the Code to allow income, estate and gift tax charitable contribution deductions for nontrust gifts of remainder interests in personal residences or farms.

Section 170(f)(4) of the Code, which relates to the income tax deduction, provides that depreciation and depletion will be taken into account in determining the value of remainder interests in real property for purposes of section 170 if the property was contributed after July 31, 1969. The Code specifically provides that depreciation shall be computed by the straight line method and that the value of a remainder interest shall be discounted at the rate of six percent, except that the Secretary of the Treasury or the Secretary's delegate may prescribe a different rate. There is no comparable provision in section 2522(c) (or section 2055 (e)) of the Code, as amended by the Tax Reform Act of 1969.

Accordingly, for Federal gift tax purposes a charitable remainder interest in a personal residence is valued without taking into consideration the elements of depreciation. Thus, in the instant case, the value of the charitable remainder interest for gift tax purposes is $21,202.74 (that is: $68,000 times .311805 (factor from Table B of section 25.2512-9(f) of the Gift Tax Regulations)).

For income tax purposes, the value of the charitable remainder interest is $14,273.74 (that is: $68,000 minus ($60,000 minus $10,000 times 20/45) times .311805). See the example in section 1.170A-12(c) of the Income Tax Regulations.

Section 2523.—Gift To Spouse

26 CFR 25.2523(a)-1: Gift to spouse; in general.

Whether a donor's failure to claim allowable gift tax marital deductions in prior taxable years will allow the donor to recover the portions of specific exemption actually claimed and equal to the amounts that should have been claimed as marital deductions. See Rev. Rul. 76-451, page 304.

Subtitle C.—Employment Taxes
Chapter 21.—Federal Insurance Contributions Act
Subchapter C.—General Provisions

Section 3121.—Definitions

26 CFR 31.3121(a)-1: Wages.
(Also Sections 61, 511, 512, 513, 3401; 1.61-2, 1.511-2, 1.512(a)-1, 1.513-1, 31.3401(a)-1)

Wages; members of religious organization paid by the organization. The small remuneration paid by a religious organization, qualifying under section 501(c)(3) of the Code, to its members for services they performed pursuant to contracts between the organization and third parties constitutes "wages" for purposes of the FICA and income tax withholding; the contract amounts paid to the organization are not includible in the members' gross income but constitute unrelated business taxable income to the organization.

Rev. Rul. 76-341

Advice has been requested whether, under the circumstances described below, amounts received by members of a religious organization (not a religious order) for services performed are wages for purposes of the Federal Insurance Contributions Act and the Collection of Income Tax at Source on Wages (chapters 21 and 24, respectively, subtitle C, Internal Revenue Code of 1954) and are includible in their gross incomes. Advice is further requested whether the amounts received by the religious organization as remuneration for the members' services are taxable to the organization as unrelated business taxable income under section 511 of the Code.

As part of its activities, the organization contracted with several private forest owners to plant seedlings on cleared forest land. Under the contracts, the organization provides all the labor necessary to perform the work and provides supervisory services for the entire operation.

The laborers furnished are generally members of the organization, although if there are not sufficient members available to do the work, the organization furnishes other laborers. The members are neither permitted to select where their services will be used nor what duties they will perform. The entire remuneration for the planting operation is paid by the forest owners to the organization, which pays the members small amounts for the work they perform.

The organization has qualified for exemption from Federal income tax under section 501(c)(3) of the Code and has filed with the Internal Revenue Service an effective Form SS-15, Certificate Waiving Exemption from Taxes Under the Federal Insurance Contributions Act, together with an accompanying list of employees who concur in the filing, Form SS-15a. Therefore, the services of its employees are "employment" unless otherwise excepted therefrom. See section 3121 (b)(8)(B) of the Federal Insurance Contributions Act.

Section 3121(a) of the Federal Insurance Contributions Act provides, with certain exceptions not here material, that the term wages means all remuneration for employment. Section 3401(a) of the Code, relating to income tax withholding, provides, with certain exceptions not here material, that the term wages means all remu-

neration for services performed by an employee for an employer.

Section 61 of the Code provides that gross income means all income from whatever source derived, including compensation for services.

Under the facts in the instant case the members of the religious organization are its employees and have no employer-employee relationship with the forest owners. Accordingly, for purposes of the Federal Insurance Contributions Act and the Collection of Income Tax at Source on Wages, the payments from the forest owners to the religious organization are not wages. However, the amounts paid by the organization to its members are wages for those purposes.

For Federal income tax purposes, the amounts received by the members from the organization are includible in gross income under section 61 of the Code.

Section 511 of the Code provides that the tax on unrelated business taxable income (as defined by section 512) shall apply in the case of any organization which is exempt from taxation under section 501(a).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed that are directly connected with the carrying on of such trade or business.

Section 513 of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(a) of the Income Tax Regulations provides that the gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) it is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activity has a causal relationship to the achievement of exempt purposes (other than for the production of income) and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Also, where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income, therefrom, does not derive from the conduct of related trade or business.

By entering into contracts with forest owners to plant trees, the organization is engaged in trade or business on a regular basis. Moreover, the conduct of this activity is not substantially related, aside from the need of the organization for income or funds, to the exercise or performance by the organization of its religious purposes.

The gross income derived by the religious organization through its contractual service arrangement with the forest owners is unrelated business taxable income within the meaning of section 512 of the Code. Accordingly, such income is subject to the tax imposed by section 511 of the Code.

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26 CFR 31.3121(a)-1: Wages.
(Also Sections 3306, 3401; 31.3306(b)-1, 31.3401(a)-1.)

Allowances; coal miner's protective clothing. Protective clothing allowances paid to coal mine employees by their employer who reasonably anticipated that the amounts would be entirely spent on such clothing are not wages for purposes of the FICA, FUTA, and income tax withholding; however, after the employer determined that it was reasonable to believe that employees spent only an average of 75 percent of the allowance on the clothing, then only 75 percent of the allowance was excludable. Rev. Rul. 69-451 modified.

Rev. Rul. 76-548

Advice has been requested whether, under the circumstances described below, amounts paid by a company to its employees as a protective clothing allowance are "wages" for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages (chapters 21, 23, and 24, respectively, subtitle C, Internal Revenue Code of 1954).

The company is in the business of constructing and repairing coal mines. Its general safety and conduct rules provide that safety clothes, including gloves, hard toe shoes, and hard hats will be worn at all times by the employees, when required. The safety clothing is not adaptable to general or continued usage to the extent that it takes the place of regular clothing.

The company entered into a good faith agreement with the employee's union to pay each of the employees a protective clothing allowance that both parties reasonably expected would be spent entirely on the protective clothing. After making the payments for a period of time, the company, in order to establish a basis for future negotiations with the union, conducted a survey and determined that it was reasonable to believe that employees spent an average of 75 percent of the

allowance on the required safety clothing. However, the company continued paying the entire amount specified in the union agreement. Such amount was separately indicated on each employee's payroll receipt.

Sections 31.3121(a)-1(h), 31.3306(b)-1(h), and 31.3401(a)-1(b)(2) of the Employment Tax Regulations provide that amounts paid to an employee specifically—either as advances are reimbursements—for traveling or other bona fide ordinary and necessary expenses incurred or reasonably expected to be incurred in the business of the employer are not wages. Such an advance or reimbursement must be identified either by making a separate payment or by specifically indicating the separate amounts where both wages and expense allowances are combined in a single payment.

In the instant case the allowance paid by the company prior to its survey was for the purpose of defraying costs it reasonably expected the employees would incur for safety clothing.

Accordingly, the protective clothing allowance received prior to the survey is not wages for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages. However, after the company determined that it was reasonable to believe that an average of only 75 percent of the allowance would be spent on protective clothing, only 75 percent of the allowance is excludable from wages for such purposes.

Compare Rev. Rul. 65-187, 1965-2 C.B. 382, which holds that a "tool allowance" paid by a company pursuant to a union contract is part of the company's wage structure and is subject to the taxes imposed by the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages. The company furnished all heavy tools and hand tools; however, as a matter of choice, many employees preferred their own hand tools. The tool allowance was paid to each union employee regardless of whether the employee used personal hand tools or those furnished by the company and no accounting was required of the employee.

Rev. Rul. 69-451, 1969-2 C.B. 180, holds that amounts charged against a so-called contract miner's account that represent taxes withheld, charges or expenditures for supplies or services for the miner's personal use (such as dues, fees, fuel, and safety clothing), assessments, and rent paid on behalf of the miner are wages for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages. In addition, amounts deducted to pay for medical and hospital expenses must be included in wages for those purposes inasmuch as those facilities are for personal use. However, the amounts paid by the company for helpers and the cost of supplies and materials furnished by it for the use of the contract miner in mining operations, which amounts are charged against the contract miner's account, are not remuneration and are not wages for Federal employment tax purposes.

Rev. Rul. 69-451 is modified to the extent it holds that amounts paid on behalf of an employee for safety clothing are for the employee's personal use and are wages for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages. See Rev. Rul. 72-110, 1972-1 C.B. 24, for the income tax treatment of amounts paid to employees.

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26 CFR 31.3121(a)-1: Wages.

Whether the amounts received by Federal civilian employees and members of the Armed Forces that must be included in gross income as compensation for services under the provisions of section 82 of the Code are wages. See Rev. Rul. 76-342, page 22.

26 CFR 31.3121(b)(6)-1: Services in employ of United States or instrumentality thereof.
(Also Section 3306; 31.3306(c)(6)-1.)

Federal employee; service for union while on leave of absence. Service performed for a union by a Federal employee on leave of absence without pay, who elected to continue participation in the U.S. Civil Service Retirement System during the period of leave, is not excepted from employment for purposes of the FICA and the FUTA.

Rev. Rul. 76-422

Advice has been requested whether, under the circumstances described below, service performed for a union by an individual on a leave of absence without pay from a government job is excepted from "employment" for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act (chapters 21 and 23, respectively, subtitle C, Internal Revenue Code of 1954).

The individual is a civilian employee of the United States Government, whose services are covered by the U.S. Civil Service Retirement System. The individual has taken a leave of absence without pay from such employment in order to serve as an officer of a union composed of government employees. Pursuant to 5 U.S.C. section 8332(k)(1)(1970), the individual has elected to make contributions to the U.S. Civil Service Retirement Fund in order to receive full retirement credit for this period of leave.

Section 3121(b)(6)(A) of the Federal Insurance Contributions Act excepts from employment service performed by an individual in the employ of the United States, if such service is covered by a retirement system established by a law of the United States.

Section 3306(c)(6) of the Federal Unemployment Tax Act excepts from employment service performed in the employ of the United States Government.

In the instant case, the individual's

service while on leave of absence from the government job to serve as an officer of a nongovernmental entity is not service in the employ of the United States, even though the individual has elected to continue participation in the U.S. Civil Service Retirement System.

Accordingly, the service performed by the individual for the union in the instant case is not excepted from employment for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act.

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26 CFR 31.3121(b)(8)-1: Services performed by a minister of a church or a member of a religious order.

Whether services performed by members of a religious order for employers outside the religious community are excepted from employment. See Rev. Rul. 76-323, page 18.

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26 CFR 31.3121(b)(8)-2: Services in employ of religious, charitable, educational, or certain other organizations exempt from income tax.
(Also Section 3306; 31.3306(c)(8)-1.)

Services prior to application for exemption. A religious organization that applies for recognition of its status more than 15 months from the end of the month in which it is organized will not be treated as a section 501(c)(3) organization for the period before its application was filed and services performed by its employees during that period are not excepted from employment for FICA and FUTA purposes.

Rev. Rul. 76-262

Advice has been requested whether under the circumstances described below, services performed for an organization are subject to the taxes imposed by the Federal Insurance Contributions Act and the Federal Unemployment Tax Act (chapters 21 and 23, subtitle C, of the Internal Revenue Code of 1954) prior to the date the organization gives notice to the Internal Revenue Service that it is applying for recognition of tax-exempt status under section 501(a) of the Code as an organization described in section 501(c)(3).

A religious organization, other than one described in section 508(c)(1)(A) of the Code, was incorporated on October 1, 1971. The organization filed Form 1023, Application for Recognition of Exemption, on April 1, 1973. As a result, the Internal Revenue Service determined on December 19, 1973, that the organization was exempt from taxation as an organization described in section 501(c)(3).

Section 508(a)(1) of the Code provides, in part, that an organization that is organized after October 9, 1969, shall not be treated as an organization described in section 501(c)(3) unless it gives notice to the Secretary or the Secretary's delegate that it is applying for such status. Section 508(a)(2) further provides such organization shall not be treated as a section 501(c)(3) organization for any period before the giving of such notice, if such notice is given after the time prescribed in the regulations for giving the notice.

Section 1.508-1(a)(2) of the Income Tax Regulations provides, in part, that an organization that is organized after October 9, 1969, must give notice that it is applying for exemption under section 501(c)(3) before March 22, 1973, or within 15 months from the end of the month in which it was organized, whichever is later.

Section 3121(a) of the Federal Insurance Contributions Act and section 3306(b) of the Federal Unemployment Tax Act provide that "wages" means all remuneration for employment. Section 3121(b)(8)(B) and section 3306(c)(8) of the respective Acts, in part, except from employment service performed in the employ of a religious, charitable, educational, or other organization described in section 501(c)(3) of the Code which is exempt from income tax under section 501(a).

Whether services performed for an organization are excepted from employment under the Federal Insurance Contributions Act and the Federal Unemployment Tax Act depends on the status of the organization. In the instant case, the organization applied for section 501(c)(3) status on April 1, 1973, which is neither within 15 months from the end of the month in which it was organized, nor before March 22, 1973. Therefore, the organization will not be treated as a section 501(c)(3) organization before the giving of such notice.

Accordingly, services performed by employees of the organization before April 1, 1973, are not excepted from "employment" and remuneration for such services is subject to the taxes imposed by the Federal Insurance Contributions Act and the Federal Unemployment Tax Act.

Section 3122.—Federal Service

Whether services performed by Federal civilian employees and members of the Armed Forces are employment and whether compensation received for such services is wages. See Rev. Rul. 76-342, page 22.

Chapter 22.—Railroad Retirement Tax Act
Subchapter C.—Tax on Employers

Section 3221.—Rate of Tax

RAILROAD RETIREMENT BOARD

RAILROAD RETIREMENT SUPPLEMENTAL ANNUITY PROGRAM

Determination of Quarterly Rate of Excise Tax

In accordance with directions in section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C. 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each man-hour for which compensation is paid by such employer for services rendered to him

during the quarter beginning October 1, 1976, shall be at the rate of twelve cents.

In accordance with directions in section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning October 1, 1976, 12.8 percent of the taxes collected under sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 87.2 percent of the taxes collected under such sections 3211(b) and 3221(c) plus one hundred percent of the taxes collected under section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated: August 12, 1976.

By Authority of the Board.

R. F. BUTLER,
Secretary of the Board.

(Filed by the Office of the Federal Register on August 18, 1976; 8:45 a.m., and published in the issue of the Federal Register for August 19, 1976, 41 F.R. 35107)

RAILROAD RETIREMENT BOARD

RAILROAD RETIREMENT SUPPLEMENTAL ANNUITY PROGRAM

Quarterly Rate of Excise Tax Determination

In accordance with directions in section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C. 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such section 3221(c) on every employer, with respect to having individuals in his employ, for each man-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning January 1, 1977, shall be at the rate of twelve and one-half cents.

In accordance with directions in section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning January 1, 1977, 13.1 percent of the taxes collected under sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 86.9 percent of the taxes collected under such sections 3211(b) and 3221(c) plus one hundred percent of the taxes collected under section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated: November 8, 1976.

By Authority of the Board.

R. F. BUTLER,
Secretary of the Board.

(Filed by the Office of the Federal Register on November 12, 1976, 8:45 a.m., and published in the issue of the Federal Register for November 15, 1976, 41 F.R. 50362)

Chapter 23.—Federal Unemployment Tax Act

Section 3306.—Definitions

26 CFR 31.3306(b)-1: Wages.

Whether amounts paid by a company to its employees as protective clothing allowances are wages. See Rev. Rul. 76-548, page 308.

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26 CFR 31.3306(c)(6)-1: Services in employ of United States or instrumentality thereof.

Whether service performed for a union by a government employee on leave of absence from the government job is excepted from employment. See Rev. Rul. 76-422, page 309.

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26 CFR 31.3306(c)(8)-1: Services in employ of religious, charitable, educational, or certain other organizations exempt from income tax.

Status of services performed for an organization prior to the date the organization gives notice to the Internal Revenue Service of its intention to apply for status under section 501(c)(3) of the Code. See Rev. Rul. 76-262, page 310.

Chapter 24.—Collection of Income Tax at Source on Wages

Section 3401.—Definitions

26 CFR 31.3401(a)-1: Wages.

Whether amounts earned by members of a religious organization performing services under contracts between it and several forest owners are wages. See Rev. Rul. 76-341, page 307.

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26 CFR 31.3401(a)-1: Wages.

Whether the amounts received by Federal civilian employees and members of the Armed Forces that must be included in gross income as compensation for services under the provisions of section 82 of the Code are wages. See Rev. Rul. 76-342, page 22.

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26 CFR 31.3401(a)-1: Wages.

Whether amounts paid by a company to its employees as protective clothing allowances are wages. See Rev. Rul. 76-548, page 308.

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26 CFR 31.3401(a)(6)-1: Remuneration for services of nonresident alien individuals paid after December 31, 1966.
(Also Section 3402; 31.3402(a)-1.)

Withholding; Australian convention. The remuneration received for services performed within the U.S. for an Australian employer by a nonresident alien who is a resident of Australia, and who is not present in the U.S. for a period or periods exceeding in the aggregate 183 days during the taxable year, is excepted from withholding provided the alien files with the employer the statement described in section 31.3401(a)(6)-1(e) of the regulations.

Rev. Rul. 76-381

Advice has been requested to what extent, under the circumstances described below, remuneration paid for services performed within the United States by a nonresident alien individual is exempt from withholding under section 3402 of the Internal Revenue Code of 1954 by virtue of

section 31.3401(a)(6)-1(e) of the Employment Tax Regulations.

X, a foreign corporation organized in Australia, operates a branch office in the United States. It is the practice of *X* to detail some of its employees that are residents of Australia to its branch office in the United States for a total of 60 days during the taxable year of such employees to replace other employees that are on leave.

Section 3402(a) of the Code provides, in part, that every employer making payments of wages shall deduct and withhold upon such wages (except as otherwise provided in this section).

Rev. Rul. 69-29, 1969-1 C.B. 273, holds that with respect to wages for services performed within the United States by nonresident alien individuals who are paid after December 31, 1966, income tax is withheld at the domestic graduated rates under section 3402 of the Code, rather than at the flat rate of 30 percent pursuant to section 1441.

Article IX of the Income Tax Treaty between Australia and the United States (Convention) provides, in part, that an individual who is a resident of Australia shall be exempt from United States tax on remuneration received in respect of personal services performed in the United States if the individual is not present within the United States for a period or periods exceeding in the aggregate 183 days during the taxable year, and the services are performed for or on behalf of an Australian resident.

Article II(1)(f) of the Convention provides that the term "Australian resident" means any person (other than a citizen of the United States or a United States corporation) who is a resident of Australia and not resident in the United States for the purposes of United States tax, but a corporation (other than a United States corporation) which is a resident of Australia shall not be deemed to be resident in the United States even though that corporation is engaged in trade or business within the United States.

Section 31.3401(a)(6)-1(e) of the regulations provides, in part, that remuneration paid for services performed within the United States by a nonresident alien individual is excepted from wages and hence is not subject to withholding if such remuneration is, or will be, exempt from the income tax imposed by Chapter 1 of subtitle A of the Code by reason of a provision of an income tax convention to which the United States is a party. For the exception to apply for any taxable year, the nonresident alien employee must furnish the employer a statement in duplicate that includes, among other things, a statement that the remuneration to be paid is, or will be, exempt from the tax imposed by Chapter 1 and the reason why such remuneration is exempt from tax. If the remuneration is claimed to be exempt from tax by reason of an income tax convention to which the United States is a party, the statement shall also indicate the provision and tax convention under which the exemption is claimed, the country of which the employee is a resident, and sufficient facts to justify the claim to exemption.

In the instant case it is contemplated that the employees that are on detail to the United States will be present for a period of not more than 183 days during a taxable year.

Therefore, the filing of a statement by an employee on detail, pursuant to section 31.3401(a)(6)-1(e) of the regulations, excepts the employee's remuneration from *X* from withholding since the remuneration will be exempt from the income tax imposed by chapter 1 of the Code by reason of the income tax convention between the United States and Australia, unless and until the employee is present in the United States for a period exceeding 183 days during the taxable year.

Accordingly, *X* is not required to withhold Federal income taxes under section 3402 of the Code provided the detailed employees file the requisite statement pursuant to section 31.3401(a)(6)-1(e) of the regulations and such employees are present in the United States not more than 183 days during the taxable year.

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26 CFR 31.3401(a)(9)-1: Remuneration for services performed by a minister of a church or a member of a religious order.

Whether remuneration received by members of religious orders from employers outside the religious community is wages. See Rev. Rul. 76-323, page 18.

Section 3402.—Income Tax Collected at Source

26 CFR 31.3402(a)-1: Requirement of withholding.

Whether remuneration paid for services performed within the United States by a nonresident alien individual is exempt from withholding. See Rev. Rul. 76-381, page 311.

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26 CFR 31.3402(a)-1: Requirement of withholding.

Treatment of daily transportation expenses incurred between an individual's residence and place of work. See Rev. Rul. 76-453, page 86.

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26 CFR 31.3402(f)(2)-1: Withholding exemption certificates.

T.D. 7423

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPNUE C, PART 31.—EMPLOYMENT TAXES; APPLICABLE ON AND AFTER JANUARY 1, 1955

Invalid withholding exemption certificates

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER
OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

By a notice of proposed rule making appearing in the Federal Register for Friday, November 14, 1975 (40 F.R. 53037), amendments to the Employment Tax Regulations (26 CFR Part 31) were proposed to provide procedures for employers who receive invalid or questionable employee's withholding exemption certificates (Forms W-4 and W-4E). On December 19, 1975, a public hearing was held on the proposed amendments. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, certain changes were made. Some of the proposed amendments of the regulations, subject to the changes indicated below, are adopted by this document; the provisions of the proposed amendments relating to questionable certificates have been withdrawn. The amendments contained in this document apply only with respect to withholding exemption certificates received by the employer after July 26, 1976.

The amendments to the regulations provide that a withholding exemption certificate which contains an alteration or unauthorized addition is invalid. A certificate is also invalid if the employee clearly indicates that it is false by an oral statement or by a written statement (other than one made on the withholding exemption certificate itself) made to the employer on or before the date on which the employee submits the certificate. In response to requests for clarification, the amendments provide that an alteration of a certificate is any deletion of any language from that provision of the certificate by which the employee certifies the correctness of the completed certificate or any material defacing of the certificate. Any writing on the certificate other than the entries requested constitutes an unauthorized addition. Accordingly, the mere fact that an employee changes an entry that he made on the certificate does not make it an invalid certificate. The amendments extend the rule as to invalidating statements by the employee to include those made prior to the date of the submission of the certificate; the change is designed to prevent circumvention of this rule by an employee who waits a day or more to submit his certificate after he has made a statement clearly indicating its falsity. The amendments further state that for purposes of determining whether or not an employee makes an invalidating statement to the employer, the term "employer" includes those individuals authorized to receive withholding exemption certificates or to perform payroll or withholding functions.

The employer must consider an invalid certificate to be a nullity for purposes of computing withholding, inform the employee that the certificate is invalid, and request another certificate from the employee. If the employee fails to comply with the employer's request, the employer must withhold from the employee as from a single person claiming no exemptions; if, however, a prior certificate is in effect with respect to the employee, the employer must continue to withhold in accordance with the prior certificate. The notice of proposed rule making would have required an employer to request another certificate only if no prior certificate were in effect; that qualification has been eliminated since, even if a prior certificate is in effect, it may well be out of date. The requirement in the notice that the employer report the receipt of an invalid certificate to the district director has also been eliminated.

The existing § 31.3401(e)-1(b), which remains in effect, provides that the employer should notify the district director when the employer has reason to believe that the number of withholding exemptions claimed on a valid certificate is excessive; a similar provision is added with respect to Forms W-4E which the employer has reason to believe incorrect.

Adoption of amendments to the regulations

On Friday, November 14, 1975, a notice of proposed rule making was published in the Federal Register (40 F.R. 53037) to provide procedures for employers who receive invalid or questionable withholding exemption certificates. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the following regulations are hereby adopted:

Paragraph 1. Paragraph (b) of § 31.3401(e)-1 is amended by adding a sentence at the end thereof to read as follows:

§ 31.3401(e)-1 Number of withholding exemptions claimed.

* * * * *

(b) * * * For rules relating to valid withholding exemption certificates, see § 31.3402(f)(2)-1(e).

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Par. 2. Section 31.3402(f)(2)-1 is amended by adding a new paragraph (e) at the end thereof. This added provision reads as follows:

§ 31.3402(f)(2)-1 Withholding exemption certificates.

* * * * *

(e) *Invalid withholding exemption certificates.* Any alteration of or unauthorized addition to a withholding exemption certificate shall cause such certificate to be invalid; see paragraph (b) of § 31.3402(f)(5)-1 for the definitions of alteration and unauthorized addition. Any withholding exemption certificate which the employee clearly indicates to be false by an oral statement or by a written statement (other than one made on the withholding exemption certificate itself) made by him to the employer on or before the date on which the employee furnishes such certificate is also invalid. For purposes of the pre-

ceding sentence, the term "employer" includes any individual authorized by the employer either to receive withholding exemption certificates, to make withholding computations, or to make payroll distributions. If an employer receives an invalid withholding exemption certificate, he shall consider it a nullity for purposes of computing withholding; he shall inform the employee who submitted the certificate that it is invalid, and shall request another withholding exemption certificate from the employee. If the employee who submitted the invalid certificate fails to comply with the employer's request, the employer shall withhold from the employee as from a single person claiming no exemptions (see § 31.3402(f)(2)-1(a)); if, however, a prior certificate is in effect with respect to the employee, the employer shall continue to withhold in accordance with the prior certificate. For instructions to employers who receive valid withholding exemption certificates which they have reason to believe may be incorrect, see § 31.3401(e)-1(b) and § 31.3402(n)-1. This paragraph applies only with respect to withholding exemption certificates received by an employer after July 26, 1976.

Par. 3. Section 31.3402(f)(5)-1 is amended to read as follows:

§ 31.3402(f)(5)-1 Form and contents of withholding exemption certificates.

(a) Forms W-4 and W-4E are the forms prescribed for the withholding exemption certificate required to be filed under section 3402(f)(2). Form W-4 is the form to be used unless the employee desires, in accordance with the provisions of § 31.3402(f)(2)-1, to use a withholding exemption certificate which contains the statements described in § 31.3402(n)-1, in which case Form W-4E is the form to be used. A withholding exemption certificate shall be prepared in accordance with the instructions and regulations applicable thereto, and shall set forth fully and clearly the data therein called for. Blank copies of Forms W-4 and W-4E will be supplied employers upon request to the district director. In lieu of the prescribed form, employers may prepare and use a form the provisions of which are identical with those of the prescribed form.

(b) A Form W-4 or W-4E does not meet the requirements of section 3402(f)(5) or this section and is invalid if it contains an alteration or unauthorized addition. For purposes of § 31.3402(f)(2)-1(e) and this paragraph—

(1) An alteration of a withholding exemption certificate is any deletion of the language of the jurat or other similar provisions of such certificate by which the employee certifies or affirms the correctness of the completed certificate, or any material defacing of such certificate;

(2) An unauthorized addition to a withholding exemption certificate is any writing on such certificate other than the entries requested (*e.g.*, name, address, and number of exemptions claimed).

Par. 4. Section 31.3402(n)-1 is amended by adding two sentences immediately before example (1) to read as follows:

§ 31.3402(n)-1 Employees incurring no income tax liability.

* * * If the employer has reason to believe that the withholding exemption certificate contains any incorrect statement, the district director should be so advised. See § 31.3402(f)(2)-1(e) for rules relating to invalid withholding exemption certificates.

* * * * * *

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved June 21, 1976.

WILLIAM M. GOLDSTEIN,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 24, 1976, 8:45 a.m., and published in the issue of the Federal Register for June 25, 1976, 41 F.R. 26216)

Chapter 25.—General Provisions Relating to Employment Taxes

Section 3505.—Liability of Third Parties Paying or Providing for Wages

26 CFR 31.3505: Statutory provisions; liability of third parties paying or providing for wages.
(Also Section 7425; 301.7425.)

T.D. 7430 [1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER C, PART 31.—EMPLOYMENT TAXES; APPLICABLE ON AND AFTER JANUARY 1, 1955; SUBCHAPTER F, PART 301.—REGULATIONS ON PROCEDURE AND ADMINISTRATION

Discharge of liens; employment tax liability of third parties paying or providing for wages

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the the Internal Revenue Service and Others Concerned:

Preamble

On May 20, 1975, a notice of proposed rule making to conform the Employment Tax Regulations (26 CFR Part 31) and the Regulations on Procedure and Administration (26 CFR Part 301) under sections 3505 (relating to the employment tax liability of third parties paying or pro-

[1] This publication of the Treasury Decision contains the full text of the publication. The individual instructions for modifying the notice of proposed rulemaking have been omitted.

viding for wages) and 7425 (relating to discharge of liens) to changes made by sections 105 (80 Stat. 1138) and 109 (80 Stat. 1141) of the Federal Tax Lien Act of 1966 [Pub. L. 89-719, 1966-2 C.B. 623] was published in the Federal Register (40 F. R. 21965).

Section 3505 generally relates to the liability of third parties paying or providing for wages. Section 31.3505-1 of the proposed regulations provided rules relating to the liability for withholding taxes imposed upon third persons who finance employers' payrolls. Generally, those provisions of the proposed regulations applied to a lender, surety, or other person who directly pays wages to the employees of another person or who supplies funds to an employer for the specific purpose of paying wages of the employees of that employer with actual notice or knowledge that the employer does not intend, or will not be able, to pay the withholding taxes.

Section 31.3505-1(b)(2) of the proposed regulations has been revised by deleting example (3). In this example, a lender advanced funds to an employer for the purpose of paying net wages of that employer with actual notice or knowledge that the employer would not be able to make timely payment of the withholding taxes. The example concluded that, for purposes of imposing liability upon the lender under section 3505, it was immaterial that after the advances the lender learned that the employer had other funds with which the taxes could have been paid. Upon reconsideration, it was concluded that, because liability under section 3505 depends upon actual notice or knowledge at the time the advance is made, example (3) was unnecessary.

Section 7425 generally relates to discharge of liens and redemption of real property by the United States. Section 301.7425-4 of the proposed regulations contained provisions relating to the redemption by the United States of real property that is sold in a nonjudicial foreclosure sale to satisfy a lien prior to a Federal tax lien on such property. Section 301.7425-4(a)(3) of the proposed regulations has been revised. The proposed regulations had provided that in a case in which the United States is not entitled to a notice of sale under section 7425(b) and 301.7425-3 (*e.g.*, where a notice of tax lien has not been filed more than 30 days before the date of sale), no right of redemption exists under section 7425(d); however, the United States would have the same right of redemption afforded any secured creditor under the applicable local law. In response to a comment, section 301.7425-4(a)(3) of the final regulations has been revised to provide that, under the circumstances stated above, the United States is afforded the same right of redemption afforded similar creditors under the applicable local law.

Section 301.7245-4(b)(1) of the proposed regulations has also been revised. Section 7425(d)(2) of the Code provides that where the United States redeems real property sold at a nonjudicial sale to satisfy a lien prior to that of the United States, the district director shall pay the amount specified in 28 United States Code § 2410. Section 7425-4(b)-1 of the proposed regulations has been revised to make clear that such section determines the amount to be paid only when the United States exercises its right of redemption under section 7425.

Adoption of amendments to the regulations

On May 20, 1975, a notice of proposed rule making was published in the Federal Register (40 F.R. 21965) in order to conform the Employment Tax Regulations (26 CFR Part 31) and the Regulations on Procedure and Administration (26 CFR Part 301) under section 3505 and 7425 of the Internal Revenue Code of 1954 to sections 105 and 109 of the Federal Tax Lien Act of 1966 (80 Stat. 1138 and 1141). Section 301.7425 and §§ 301.7425-1 through 301.7425-4 (inclusive) of the regulations hereby adopted supersede §§ 400.4, 400.4-1, 400.5 and 400.5-1 of this chapter, relating to section 109 of the Federal Tax Lien Act of 1966, which were prescribed by T.D. 6944 1968-1 C.B. 854, approved January 17, 1968 (33 F.R. 732). After taking into consideration all such relevant matter as was presented by interested persons regarding the rules proposed, the following amendments of the regulations are hereby adopted:

In order to provide regulations under section 3505 of the Internal Revenue Code of 1954, as added by section 105(a) of the Federal Tax Lien Act of 1966 (Pub. L. 89-719, 80 Stat. 1138 [1966-2 C.B. 623]) and under section 7425 of such Code, as added by section 109 of such Act (80 Stat. 1141), the Employment Tax Regulations (26 CFR Part 31) and the Regulations on Procedure and Administration (26 CFR Part 301) are amended as follows. Section 301.7425 and §§ 301.7425-1 through 301.7425-4 (inclusive) of the regulations hereby adopted supersede §§ 400.4, 400.4-1, 400.5, and 400.5-1 of this chapter (Temporary Regulations under the Federal Tax Lien Act of 1966) which were prescribed by T.D. 6944 1968-1 C.B. 854, approved January 17, 1968 (33 F.R. 732).

EMPLOYMENT TAX REGULATIONS (26 CFR Part 31)

Paragraph 1. There are added immediately after § 31.3504-1 the following new sections:

§ 31.3505 Statutory provisions; liability of third parties paying or providing for wages.

Sec. 3505. *Liability of third parties paying or providing for wages*—(a) *Direct payment by third parties.* For purposes of sections 3102, 3202, 3402, and 3403, if a lender, surety, or other person, who is not an employer under such sections with re-

spect to an employee or group of employees, pays wages directly to such an employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.

(b) *Personal liability where funds are supplied.* If a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323(i)(1)) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose.

(c) *Effect of payment.* Any amounts paid to the United States pursuant to this section shall be credited against the liability of the employer.

[Sec. 3505 as added by sec. 105(a), Federal Tax Lien Act 1966 (80 Stat. 1138) [Pub. L. 89-719, 1966-2 C.B. 623]]

§ 31.3505-1 Liability of third parties paying or providing for wages.

(a) *Personal liability in case of direct payment of wages*—(1) *In general.* A lender, surety, or other person—

(i) Who is not an employer for purposes of section 3102 (relating to deduction of tax from wages under the Federal Insurance Contributions Act), section 3202 (relating to deduction of tax from compensation under the Railroad Retirement Tax Act), or section 3402 (relating to deduction of income tax from wages) with respect to an employee or group of employees, and

(ii) Who pays wages on or after January 1, 1967, directly to such employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees,

shall be liable in his person and estate for payment to the United States of an amount equal to the sum of the taxes required to be deducted and withheld from those wages by the employer under subtitle C of the Code and interest from the due date of the employer's return relating to such taxes for the period in which the wages are paid.

(2) *Example:* The provisions of this paragraph may be illustrated by the following example:

Example. Pursuant to a wage claim of $200, A, a surety company, paid a net amount of $158 to B, an employee of the X Construction Company. This was done in accordance with A's payment bond covering a private construction job on which B was an employee. If X Construction Company fails to make timely payment or deposit of $42.00, the amount of tax required by subtitle C of the Code to be deducted and withheld from a $200 wage payment to B, A becomes personally liable for $42.00 (*i.e.*, an amount equal to the unpaid taxes), plus interest upon this amount from the due date of X's return.

(b) *Personal liability where funds are supplied*—

(1) *In general,* A lender, surety, or other person who—

(i) Advances funds to or for the account of an employer for the specific purpose of paying wages of the employees of that employer, and

(ii) At the time the funds are advanced, has actual notice or knowledge (within the meaning of section 6323(i)(1)) that the employer does not intend to, or will not be able to, make timely payment or deposit of the amounts of tax required by subtitle C of the Code to be deducted and withheld by the employer from those wages,

shall be liable in his own person and estate for payment to the United States of an amount equal to the sum of the taxes which are required by subtitle C of the Code to be deducted and withheld from wages paid on or after January 1, 1967, and which are not paid over to the United States by the employer, and interest from the due date of the employer's return relating to such taxes. However, the liability of the lender, surety, or other person for such taxes shall not exceed 25 percent of the amount supplied by him for the payment of wages. The preceding sentence and the second sentence of section 3505(b) limit the liability of a lender, surety, or other person arising solely by reason of section 3505, and they do not limit the liability which the lender, surety or other person may incur to the United States as a third-party beneficiary of an agreement between the lender, surety, or other person and the employer. The liability of a lender, surety, or other person does not include penalties imposed on the taxpayer.

(2) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). D, a savings and loan association, advances $10,000 to Y for the specific purpose of paying the net wages of Y's employees. D advances those funds with knowledge that Y will not be able to make timely payment of the taxes required to be deducted and withheld from these wages by subtitle C of the Code. Y uses the $10,000 to pay the net wages of his employees but fails to remit withholding taxes under subtitle C in the amount of $2,600. D's liability, under this section, is limited to $2,500, 25 percent of the amount supplied for the payment of wages to Y's employees, plus interest thereon.

Example (2). E, a loan company, advances $15,000 to F, a contractor, for the specific purpose of paying $20,000 of net wages due to F's employees. E advances those funds with knowledge that F will not be able to make timely payment of the taxes required to be deducted and withheld from these wages by subtitle C of the Code. F applies $5,000 of its own funds toward payment of these wages. The amount of tax required to be deducted and withheld from the gross wages is $4,500. The limitation applicable to E's liability for withholding taxes is $3,750 (25% of $15,000). However, because E furnished only a portion of the total net wages, E is liable for $3,375 of the taxes required to be deducted and withheld ($4,500 x $15,000/$20,000) plus interest thereon.

(3) *Ordinary working capital loan.* The provisions of section 3505(b) do not apply in the case of an ordinary working capital loan made to an em-

ployer, even though the person supplying the funds knows that part of the funds advanced may be used to make wage payments in the ordinary course of business. Generally, an ordinary working capital loan is a loan which is made to enable the borrower to meet current obligations as they arise. The person supplying the funds is not obligated to determine the specific use of an ordinary working capital loan or the ability of the employer to pay the amounts of tax required by subtitle C of the Code to be deducted and withheld. However, section 3505 (b) is applicable where the person supplying the funds has actual notice or knowledge (within the meaning of section 6323(i)(1)) at the time of the advance that the funds, or a portion thereof, are to be used specifically to pay net wages, whether or not the written agreement under which the funds are advanced states a different purpose. Whether or not a lender has actual notice or knowledge that the funds are to be used to pay net wages, or merely that the funds may be so used, depends upon the facts and circumstances of each case. For example, a lender, who has actual notice or knowledge that the withheld taxes will not be paid, will be deemed to have actual notice or knowledge that the funds are to be used specifically to pay net wages where substantially all of the employer's ordinary operating expenses consist of salaries and wages even though funds for other incidental operating expenses may be supplied pursuant to an agreement described as a working capital loan agreement.

(c) *Definition of other person*—(1) *In general.* As used in this section, the term "other person" means any person who directly pays the wages or supplies funds for the specific purpose of paying the wages of an employee or group of employees of another employer. It does not include a person acting only as agent of the employer or as agent of the employees.

(2) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Pursuant to an agreement between L, a labor union, and M, an employer, M makes monthly vacation payments (of a sum equal to a certain percentage of the remuneration paid to each union member employed by M during the previous month) to a union administered pool plan under which each employee's rights are fully vested and nonforfeitable from the time the money is paid by M. Vacation allowances are accumulated by the plan and distributed to eligible employees during their vacations. L, acting merely as a conduit with respect to these payments, would incur no liability under section 3505.

Example (2). N, a construction company, maintains a payroll account with the O Bank in which N deposits its own funds. Pursuant to an automated payroll service agreement between N and O, O prepares payroll checks and earnings statements for each of N's employees reflecting the net pay due each such employee. These checks are delivered to N for signature. After the checks are signed, O distributes them directly to N's employees on the regularly scheduled pay day. O, acting only in the capacity of a disbursing agent of N's funds, would incur no liability under section 3505 with respect to these payroll distributions. However, O may incur liability under section 3505 in the capacity of a lender if it supplies the funds for the payment of wages.

(d) *Payment of taxes and interest*—(1) *Procedure for payment.* A lender, surety, or other person may satisfy the personal liability imposed upon him by section 3505 by executing Form 4219 and filing it, accompanied by payment of the amount of tax and interest due the United States, in accordance with the instructions for the form. In the event the lender, surety, or other person does not satisfy the liability imposed by section 3505, the United States may collect the liability by appropriate civil proceeding commenced within 6 years after assessment of the tax against the employer.

(2) *Effect of payment*—(i) *In general.* A person paying the amounts of tax required to be deducted and withheld by subtitle C of the Code as a result of section 3505 and this section is not required to pay the employer's portion of the payroll taxes upon those wages, or file an employer's tax return with respect to those wages, or furnish annual wage and tax statements to the employees.

(ii) *Amounts paid by a lender, surety, or other person.* Any amounts paid by the lender, surety, or other person to the United States pursuant to this section shall be credited against the liability of the employer on whose behalf those payments are made and shall also reduce the total liability imposed upon the lender, surety, or other person under section 3505 and this section.

(iii) *Amounts paid by the employer.* Any amounts paid to the United States by an employer and applied to his liability under subtitle C of the Code shall reduce the total liability imposed upon that employer by subtitle C. Such payments will also reduce the liability imposed upon a lender, surety, or other person under section 3505 except that such liability shall not be reduced by any portion of an employer's payment applied against the employer's liability under subtitle C which is in excess of the total liability imposed upon the lender, surety, or other person under section 3505. For example, if a lender supplies $1,000 to an employer for the payment of net wages, upon which $300 withholding tax liability is imposed, a part-payment of $25 by the employer which is applied to this liability would reduce the employer's total liability under subtitle C of the Code by that amount, but the liability imposed upon the lender by section 3505(b) in an amount equal to the withholding tax liability of the employer, which is limited to 25 percent of the amount supplied by him, would remain $250. However, if the employer makes another payment of $200 which is applied to his liability for the withholding taxes, the lender's liability under section 3505 attributable to the withholding taxes is reduced by $175 ($225 less $50 (the amount by which the employer's liability exceeds the lender's liability after application of the limitation)). Thus, after the

second payment by the employer, the lender's liability under section 3505 (b) is $75 ($250 less $175) plus interest due on the underpayment for the period of underpayment.

(e) *Returns required by employers and statements for employees.* This section does not relieve the employer of the responsibilities imposed upon him to file the returns and supply the receipts and statements required under subchapter A, Chapter 61 of the Code (relating to returns and records).

(f) *Time when liability arises.* The liability under section 3505 and this section of a lender, surety, or other person paying or supplying funds for the payment of wages is incurred on the last day prescribed for the filing of the employer's Federal employment tax return (determined without regard to any extension of time) in respect of such wages.

REGULATIONS ON PROCEDURE AND ADMINISTRATION

(26 CFR Part 301)

Par. 2. Section 301.7425 is amended by renumbering such section, by renumbering section 7425 of such section, and by adding a historical note. These renumbered and added provisions read as follows:

§ 301.7427 Statutory provisions; cross references.

Sec. 7427. *Cross references.* * * *

[Sec. 7427 as renumbered by sec. 109, Federal Tax Lien Act 1966 (80 Stat. 1141) [Pub. L. 89-719, 1966-2 C.B. 623]]

Par. 3. There are added immediately after § 301.7424-1 the following new sections:

§ 301.7425 Statutory provisions; discharge of liens.

(a) Section 7425 of the Internal Revenue Code of 1954, as added by section 109 of the Federal Tax Lien Act of 1966:

Sec. 7425. *Discharge of liens*—(a) *Judicial proceedings.* If the United States is not joined as a party, a judgment in any civil action or suit described in subsection (a) of section 2410 of title 28 of the United States Code, or a judicial sale pursuant to such a judgment, with respect to property on which the United States has or claims a lien under the provisions of this title—

(1) Shall be made subject to and without disturbing the lien of the United States, if notice of such lien has been filed in the place provided by law for such filing at the time such action or suit is commenced, or

(2) Shall have the same effect with respect to the discharge or divestment of such lien of the United States as may be provided with respect to such matters by the local law of the place where such property is situated, if no notice of such lien has been filed in the place provided by law for such filing at the time such action or suit is commenced or if the law makes no provision for such filing.

If a judicial sale of property pursuant to a judgment in any civil action or suit to which the United States is not a party discharges a lien of the United States arising under the provisions of this title, the United States may claim, with the same priority as its lien had against the property sold, the proceeds (exclusive of costs) of such sale at any time before the distribution of such proceeds is ordered.

(b) *Other sales.* Notwithstanding subsection (a) a sale of property on which the United States has or claims a lien, or a title derived from enforcement of a lien, under the provisions of this title, made pursuant to an instrument creating a lien on such property, pursuant to a confession of judgment on the obligation secured by such an instrument, or pursuant to a nonjudicial sale under a statutory lien on such property—

(1) Shall, except as otherwise provided, be made subject to and without disturbing such lien or title, if notice of such lien was filed or such title recorded in the place provided by law for such filing or recording more than 30 days before such sale and the United States is not given notice of such sale in the manner prescribed in subsection (c)(1); or

(2) Shall have the same effect with respect to the discharge or divestment of such lien or such title of the United States, as may be provided with respect to such matters by the local law of the place where such property is situated, if—

(A) Notice of such lien or such title was not filed or recorded in the place provided by law for such filing more than 30 days before such sale,

(B) The law makes no provision for such filing, or

(C) Notice of such sale is given in the manner prescribed in subsection (c)(1).

(c) *Special Rules*—(1) *Notice of sale.* Notice of a sale to which subsection (b) applies shall be given (in accordance with regulations prescribed by the Secretary or his delegate) in writing, by registered or certified mail or by personal service, not less than 25 days prior to such sale, to the Secretary or his delegate.

(2) *Consent to sale.* Notwithstanding the notice requirement of subsection (b)(2)(C), a sale described in subsection (b) of property shall discharge or divest such property of the lien or title of the United States if the United States consents to the sale of such property free of such lien or title.

(3) *Sale of perishable goods.* Notwithstanding the notice requirement of subsection (b)(2)(C), a sale described in subsection (b) of property liable to perish or become greatly reduced in price or value by keeping, or which cannot be kept without great expense, shall discharge or divest such property of the lien or title of the United States if notice of such sale is given (in accordance with regulations prescribed by the Secretary or his delegate) in writing, by registered or certified mail or by personal service, to the Secretary or his delegate before such sale. The proceeds (exclusive of costs) of such sale shall be held as a fund subject to the liens and claims of the United States, in the same manner and with the same priority as such liens and claims had with respect to the property sold, for not less than 30 days after the date of such sale.

(d) *Redemption by United States*—(1) *Right to redeem.* In the case of a sale of real property to which subsection (b) applies to satisfy a lien prior to that of the United States, the Secretary or his delegate may redeem such property within the period of 120 days from the date of such sale or the period allowable for redemption under local law, whichever is longer.

(2) *Amount to be paid.* In any case in which the United States redeems real property pursuant to paragraph (1), the amount to be paid for such property shall be the amount prescribd by subsection (d) of section 2410 of title 28 of the United States Code.

(3) *Certificate of redemption*—(A) *In general.* In any case in which real property is redeemed by the United States pursuant to this subsection, the Secretary or his delegate shall apply to the officer designated bv local law, if any, for the documents necessary to evidence the fact of redemption and to record title to such property in the name of the United States. If no such officer is designated by local law or if such officer fails to issue such document,s the Secretary or his delegate shall execute a certificate of redemption therefor.

(B) *Filing.* The Secretary or his delegate shall, without delay, cause such documents or certificate to be duly recorded in the proper registry of deeds. If the State in which the real property redeemed by the United States is situated has not by law designated an office in which such certificate may be recorded, the Secretary or his delegate shall file such certificate in the office of the clerk of the United States district court for the judicial district in in which such property is situated.

(C) *Effect.* A certificate of redemption executed by the Secretary or his delegate shall constitute prima facie evidence of the regularity of such redemption and shall, when recorded, transfer to the United States all the rights, title, and interest in and to such property acquired by the person from whom the United States redeems such property by virtue of the sale of such property.

[Sec. 7425 as added by sec. 109, Federal Tax Lien Act of 1966 (80 Stat. 1141)]

(b) Section 2410 of title 28 of the United States Code, as amended by section 201 of the Federal Tax Lien Act of 1966:

Sec. 2410. Actions affecting property on which United States has lien. * * *

(d) In any case in which the United States redeems real property under * * * section 7425 of the Internal Revenue Code of 1954, the amount to be paid for such property shall be the sum of—

(1) The actual amount paid by the purchaser at such sale (which, in the case of a purchaser who is the holder of the lien being foreclosed, shall include the amount of the obligation secured by such lien to the extent satisfied by reason of such sale),

(2) Interest on the amount paid (as determined under paragraph (1)) at 6 percent per annum from the date of such sale, and

(3) The amount (if any) equal to the excess of (A) the expenses necessarily incurred in connection with such property, over (B) the income from such property plus (to the extent such property is used by the purchaser) a reasonable rental value of such property.

[Sec. 2410(d) as amended by sec. 201, Federal Tax Lien Act 1966 (80 Stat. 1147)]

§ 301.7425-1 Discharge of liens; scope and application; judicial proceedings.

(a) *In general.* A tax lien of the United States, or a title derived from the enforcement of a tax lien of the United States, may be discharged or divested under local law only in the manner prescribed in section 2410 of Title 28 of the United States Code or in the manner prescribed in section 7425 of the Internal Revenue Code. Section 7425(a) contains provisions relating to the discharge of a lien when the United States is not joined as a party in the judicial proceedings described in subsection (a) of section 2410 of Title 28 of the United States Code. These judicial proceedings are plenary in nature and proceed on formal pleadings. Section 7425(b) contains provisions relating to the discharge of a lien or a title derived from the enforcement of a lien in the event of a nonjudicial sale with respect to the property involved. Section 7425(c) contains special rules relating to the notice of sale requirements contained in section 7425(b). Section 301.7425-2 contains rules with respect to the nonjudicial sales described in section 7425(b). Paragraph (a) of § 301.7425-3 contains rules with respect to the notice of sale provisions of section 7425(c)(1). Paragraph (b) of § 301.7425-3 contains rules relating to the consent to sale provisions of section 7425(c)(2). Paragraph (c) of § 301.7425-3 contains rules relating to the sale of perishable goods provisions of section 7425(c)(3). Paragraph (d) of § 301.7425-3 contains the requirements with respect to the contents of a notice of sale. Section 301.7425-4 prescribes rules with respect to the redemption of real property by the United States.

(b) *Effective date.* The provisions of section 7425, as added by the Federal Tax Lien Act of 1966, are effective with respect to sales described in section 7425 occurring after November 2, 1966. The notice of sale provisions of section 7425(c)(1) or (3) do not apply to sales occurring after November 2, 1966, if the seller of the property performed an act before November 3, 1966, which act at the time of performance was required and effective under local law with respect to the sale. An example of such an act is publication of a notice of the sale in a local newspaper before November 3, 1966, if local law requires such publication before a sale and the publication is effective under local law. Accordingly, in such a case, it is not necessary to notify the Internal Revenue Service pursuant to the provisions of section 7425(c)(1) or (3). With respect to a notice of sale required under section 7425(c)(1) or (3)—

(1) Any notice of sale given to an office of the Internal Revenue Service or the Treasury Department during the period November 3, 1966, through December 21, 1966, shall be considered as adequate;

(2) Any notice of sale given during the period December 22, 1966, through January 31, 1968, which complies with the provisions of either—

(i) Revenue Procedure 67-25, 1967-1 C.B. 626 (based on Technical Information Release 873, dated December 22, 1966), or

(ii) Section 301.7425-3 shall be considered as adequate; and

(3) Any notice of sale given after January 31, 1968, which complies with the provisions of § 301.7425-3 shall be considered as adequate.

(c) *Judicial proceedings*—(1) *In general.* Section 7425(a) provides rules, where the United States is not joined as a party, to determine the effect of a judgment in any civil action or suit described in subsection (a) of section 2410 of title 28 of the United States Code (relating to joinder of the United States in certain proceedings), or a judicial sale pursuant to such a judgment, with respect to property on which the United States has or claims a lien under the provisions of this title. If the United States is improperly named as a party to a judicial proceeding, the effect is the same as if the United States were not joined.

(2) *Notice of lien filed when the proceeding is commenced.* Where the United States is not properly joined as a party in the court proceeding and a notice of lien has been filed in accordance with section 6323(f) or (g) in the place provided by law for such filing at the time the action or suit is commenced, a judgment or judicial sale pursuant to such a judgment shall be made subject to and without disturbing the lien of the United States.

(3) *Notice of lien not filed when the proceeding is commenced.*—(i)

General rule. Where the United States is not joined as a party in the court proceeding and either a notice of lien has not been filed in accordance with section 6323(f) or (g) in the place provided by law for such filing at the time the action or suit is commenced, or the law makes no provision for that filing, a judgment or judicial sale pursuant to such a judgment shall have the same effect with respect to the discharge or divestment of the lien of the United States as may be provided with respect to these matters by the local law of the place where the property is situated.

(ii) *Examples.* The provisions of subparagraph (3) may be illustrated by the following examples:

Example (1). A, the first mortgagee of an apartment building located in State Y, commenced a foreclosure action on the mortgage prior to the time that a notice of a Federal tax lien, on that building, had been filed. Under the law of Y, junior liens on real property are discharged by a judicial sale pursuant to a judgment in a foreclosure action. Therefore, the Federal tax lien on the building will be discharged by the judicial sale. This result is the same whether the tax lien arose before or after the date of commencement of the foreclosure action and whether notice of the tax lien was filed at any time after commencement of the foreclosure action.

Example (2). On January 10, 1969, B dies testate and devises Blackacre to C. At B's death, Blackacre is subject to a first mortgage held by D. Realty is subject to administration as part of a decedent's estate under the laws of State X. However, C takes possession of Blackacre with the assent of E, the executor of B's estate. On January 5, 1970, D commences a foreclosure action on the mortgage. Under the law of X, junior liens in real property are discharged by a judicial sale pursuant to a judgment in a foreclosure action. After commencement of the proceedings, an assessment for estate taxes is made and, thereafter, a notice of lien is filed in accordance with section 6323. The special lien on Blackacre, arising at the date of B's death, for estate taxes under section 6324(a) will be discharged by the judicial sale because there are no provisions for filing a notice thereof under law and junior liens are discharged by the sale under local law. The lien is discharged even though the executor failed to obtain a discharge of his personal liability under section 2204. Furthermore, the general lien on Blackacre under section 6321 will be discharged by the judicial sale because the foreclosure action was commenced prior to the time that a notice of lien was filed.

(4) *Proceeds of a judicial sale.* If a judicial sale of property pursuant to a judgment in any civil action or suit to which the United States is not a party discharges a lien of the United States arising under the provisions of the Internal Revenue Code of 1954, the United States may claim the proceeds of the sale (exclusive of costs) prior to the time that distribution of the proceeds is ordered. The claim of the United States in such a case is treated as having the same priority with respect to the proceeds as the lien had with respect to the property which was discharged from the lien by the judicial sale.

§ 301.7425-2 Discharge of liens; nonjudicial sales.

(a) *In general.* Section 7425(b) contains provisions with respect to the effect on the interest of the United States in property in which the United States has or claims a lien, or a title derived from the enforcement of a lien, of a sale made pursuant to—

(1) An instrument creating a lien on the property sold,

(2) A confession of judgment on the obligation secured by an instrument creating a lien on the property sold, or

(3) A statutory lien on the property sold.

For purposes of this section, such a sale is referred to as a "nonjudicial sale." The term "nonjudicial sale" includes, but is not limited to, the divestment of the taxpayer's interest in property which occurs by operation of law, by public or private sale, by forfeiture, or by termination under provisions contained in a contract for a deed or a conditional sales contract. Under section 7425(b)(1), if a notice of lien is filed in accordance with section 6323(f) or (g), or the title derived from the enforcement of a lien is recorded as provided by local law, more than 30 days before the date of sale, and the appropriate district director is not given notice of the sale (in the manner prescribed in § 301.7425-3), the sale shall be made subject to and without disturbing the lien or title of the United States. Under section 7425(b)(2)(C), in any case in which notice of the sale is given to the district director not less than 25 days prior to the date of sale (in the manner prescribed in section 7425(c)(1)), the sale shall have the same effect with respect to the discharge or divestment of the lien or title as may be provided by local law with respect to other junior liens or other titles derived from the enforcement of junior liens. A nonjudicial sale pursuant to a lien which is junior to a tax lien does not divest the tax lien, even though notice of the nonjudicial sale is given to the appropriate district director. However, under the provisions of section 6325(b) and § 301.6325-1, a district director may discharge the property from a tax lien, including a tax lien which is senior to another lien upon the property.

(b) *Date of sale.* In the case of a nonjudicial sale subject to the provisions of section 7425(b), in order to compute any period of time determined with reference to the date of sale, the date of sale shall be determined in accordance with the following rules:

(1) In the case of divestment of junior liens on property resulting directly from a public sale, the date of sale is deemed to be the date the public sale is held, regardless of the date under local law on which junior liens on the property are divested or the title to the property is transferred,

(2) In the case of divestment of junior liens on property resulting directly from a private sale, the date of sale is deemed to be the date title to the property is transferred, regardless of the date junior liens on the property are divested under local law, and

(3) In the case of divestment of

junior liens on property not resulting directly from a public or private sale, the date of sale is deemed to be the date on which junior liens on the property are divested under local law.

For provisions relating to the right of redemption of the United States, see section 7425(d) and § 301.7425-4.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). (i) Under the law of State M, upon entry of judgment, the judgment creditor obtains a statutory lien upon the real property of the judgment debtor, and certain procedures are provided by which the judgment creditor may execute by public sale upon such real property. These procedures provide, among other things, for notification by personal service or registered or certified mail to other lien creditors, if any, and publication of a notice of the sale in a local newspaper. After the expiration of a prescribed period of time after such notification and publication, the sheriff of the county where the real property is located may sell the property at public sale. After payment of the amount bid at the public sale, the sheriff issues to the purchaser a deed to the real property, and the interests of junior lienors in the property are divested.

(ii) For purposes of this section, such an execution sale is a nonjudicial sale described in section 7425(b) because the sale is made pursuant to a statutory lien on the property sold. The date of sale, for purposes of computing a period of time determined with reference to the date of sale, is the date on which the public sale is held because junior liens on the real property are divested directly as a result of the public sale. This result obtains even though the junior liens are legally divested on a later date when the sheriff issues the deed.

Example (2). (i) Under the law of State N, mortgages on real property may contain a power of sale which authorizes the mortgagee, upon breach by the mortgagor of one of the conditions of the mortgage, to have the mortgaged property sold at public sale. This public sale must be preceded by notice by advertisement in a local newspaper, and the time, place, description of the property, and other terms of the sale must be specified. The purchaser at such a public sale obtains a title to the real property which is not subject to a right of redemption by the mortgagor and which divests the interests of the junior lienors in the property.

(ii) For purposes of this section, a sale pursuant to such a power of sale is a nonjudicial sale described in section 7425(b) because the sale is made pursuant to the mortgage instrument which created a lien on the property sold. The date of the sale, for purposes of computing a period of time determined with reference to the date of sale, is the date of the public sale because junior liens on the property are divested directly as a result of the public sale.

Example (3). Assume the same facts as in example (2) except that the purchaser at the public sale obtains a title which is defeasible by the exercise of a right of redemption in the mortgagor. The purchaser's title divests the interests of junior lienors in the property as of the time of public sale. The interests of junior lienors in the property revive if the mortgagor exercises his right of redemption. The date of the sale, for purposes of computing a period of time determined with reference to the date of sale, is the date of the public sale because junior liens on the property are divested directly as a result of the public sale although such junior liens may be revived by a subsequent redemption by the mortgagor.

Example (4). (i) Under the law of State O, upon breach by a mortgagor of real property of one of the conditions of the mortgage, the mortgagee may foreclose the mortgage by securing possession of the property by one of several procedures provided by statute. These procedures are generally referred to as "strict foreclosure." In order for a foreclosure to be effective under these procedures, a certificate attesting the fact of entry must be recorded with the proper registrar of deeds within 30 days after the mortgagee enters the property. During the one-year period following the date on which the certificate of entry is recorded, the mortgagor or a junior lien or may redeem the property by paying the mortgagee the amount of the mortgage obligation. If, during such one-year period the property is not redeemed and the mortgagee's possession is continued, the interests of the mortgagor and the junior lienors in the property are divested as of the date such one-year period expires.

(ii) For purposes of this section, such a foreclosure procedure is a nonjudicial sale described in section 7425(b) because it results in the divestment of the mortgagor's interest in the property by operation of law pursuant to the mortgage which created a lien on the property. In addition, because there is no public or private sale which directly results in the divestment of junior liens on the property, the date of sale, for purposes of computing a period of time determined with reference to the date of sale, is the date on which the one-year period following the recording of the certificate of entry expires.

Example (5). The law of State P contains a procedure which permits a county to collect a delinquent tax assessment with respect to real property by the means of a tax sale of the property. First, a notice of a public auction with respect to the tax assessment on the real property is published in a local newspaper. At the public auction, the purchaser, upon payment of the delinquent taxes and interest, obtains from the county tax collector a tax certificate with respect to the real property. Because the obtaining of this tax certificate does not directly result in the divestment of either the owner's title or junior liens with respect to the property, the public auction is not a nonjudicial sale described in section 7425(b). At any time before a tax deed with respect to the property is issued by the clerk of the county court, the owner or any holder of a lien or other interest with respect to the property may obtain the tax certificate by paying the holder of the tax certificate the amount of the taxes, interest, and costs. After a date which is two years after the date on which the tax assessment became delinquent, the holder of the tax certificate may request the clerk of the county court to have the property advertised for sale. After advertisement of the sale, the clerk of the county court conducts a public sale of the real property and the purchaser obtains a tax deed. The interests of all junior lienors in the property are divested and the property is not subject to a right of redemption under the law of State P. For purposes of this section, this public sale is considered to be a nonjudicial sale described in section 7425(b) because the sale is made pursuant to a statutory lien on the property sold. The date of the sale, for purposes of computing a period of time determined with reference to the date of sale, is the date on which the public sale is held at which the purchaser obtains a tax deed as this sale directly results in the divestment of junior liens on the property.

Example (6). The law of State Q contains a provision which permits a county to collect a delinquent tax assessment with respect to real property by the means of a tax sale of the property. After public notice is given, a "tax sale" of the real property is conducted. Upon payment of the delinquent taxes and interest, a purchaser obtains a tax certificate with respect to the real property. If there is no purchaser at the tax sale, the property is deemed to be bid in by the State. Because the obtaining of this tax certificate by a purchaser or State Q does not directly result in the divestment of either the owner's title or junior liens with respect to the property, the tax sale is not a nonjudicial sale described in section 7425(b). Following the tax sale, there is a three year period during which any person having an interest in the property may redeem the property by paying the holder of the tax certificate the amount of taxes, interest, and costs. Unless redeemed, the holder of the tax certificate may obtain an absolute title at the expiration of the period of redemption provided he serves a notice of the expiration of the redemption period upon the owner at least 60 days prior to the date of expiration. Because there is no public or private sale which directly re-

sults in the divestment of junior liens on the property, the date of sale, for purposes of computing a period of time determined with reference to the date of sale, is the date on which the holder of the tax certificate obtains absolute title.

§ 301.7425-3 Discharge of liens; special rules.

(a) *Notice of sale requirements*—(1) *In general.* Except in the case of the sale of perishable goods described in paragraph (c) of this section, a notice (as described in paragraph (d) of this section) of a nonjudicial sale shall be given, in writing by registered or certified mail or by personal service, not less than 25 days prior to the date of sale (determined under the provisions of paragraph (b) of § 301.7425-2), to the district director (marked for the attention of the chief, special procedures staff) for the internal revenue district in which the sale is to be conducted. Thus, under this section, a notice of sale is not effective if it is given to a district director other than the district director for the internal revenue district in which the sale is to be conducted. The provisions of sections 7502 (relating to timely mailing treated as timely filing) and 7503 (relating to time for performance of acts where the last day falls on Saturday, Sunday, or a legal holiday) apply in the case of notices required to be made under this paragraph.

(2) *Postponement of scheduled sale*—(i) *Where notice of sale is given.* In the event that notice of a sale is given in accordance with subparagraph (1) of this paragraph with respect to a scheduled sale which is postponed to a later time or date, the seller of the property is required to give notice of the postponement to the district director in the same manner as is required under local law with respect to other secured creditors. For example, assume that in State M local law requires that in the event of a postponement of a scheduled foreclosure sale of real property, an oral announcement of the postponement at the place and time of the scheduled sale constitutes sufficient notice to secured creditors of the postponement. Accordingly, if at the place and time of a scheduled sale in State M an oral announcement of the postponement is made, the Internal Revenue Service is considered to have notice of the postponement for the purpose of this subparagraph.

(ii) *Where notice of sale is not given.* In the event that—

(A) Notice of a nonjudicial sale would not be required under subparagraph (1) of this paragraph if the sale were held on the originally scheduled date,

(B) Because of a postponement of the scheduled sale, more than 30 days elapse between the originally scheduled date of the sale and the date of the sale, and

(C) A notice of lien with respect to the property to be sold is filed more than 30 days before the date of the sale,

notice of the sale is required to be given to the district director in accordance with the provisions of subparagraph (1) of this paragraph. In any case in which notice of sale is required to be given with respect to a scheduled sale, and notice of the sale is not given, any postponement of the scheduled sale does not affect the rights of the United States under section 7425(b).

(iii) *Examples.* The provisions of subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example (1). A nonjudicial sale of Blackacre, belonging to A, a delinquent taxpayer, is scheduled for December 2, 1968. As no notice of lien is filed applicable to Blackacre more than 30 days before December 2, 1968, no notice of sale is given to the district director. On December 2, 1968, the sale of Blackacre is postponed until January 15, 1969. A notice of lien with respect to Blackacre is properly filed on January 2, 1969. The sale of Blackacre is held on January 15, 1969. Even though more than 30 days elapsed between the originally scheduled date of the sale (December 2, 1968) and the date of the sale (January 15, 1969), no notice of sale is required to be given to the district director because the notice of lien was not filed more than 30 days before the date of the sale.

Example (2). Assume the same facts as in example (1) except that a notice of lien is filed on November 29, 1968 in accordance with section 6323. Because more than 30 days elapsed between the originally scheduled date of the sale and the date of the sale, and the notice of lien is filed (on November 29, 1968) more than 30 days before the date of the sale (January 15, 1969), notice of the sale, in accordance with the provisions of subparagraph (1) of this paragraph, is required to be given to the district director.

Example (3). A nonjudicial sale of Whiteacre, belonging to B, a delinquent taxpayer, is scheduled for December 2, 1968. A notice of lien applicable to Whiteacre is filed on November 12, 1968 in accordance with section 6323. As the notice of lien was not filed more than 30 days before December 2, 1968, no notice of sale is given to the district director. On December 2, 1968, the sale of Whiteacre is postponed until December 20, 1968. The sale of Whiteacre is held on December 20, 1968. Even though more than 30 days elapsed between the date notice of lien was filed (November 12, 1968) and the date of the sale (December 20, 1968), no notice of sale is required to be given to the district director because not more than 30 days elapsed between the date of the originally scheduled sale (December 2, 1968) and the date the sale was actually held (December 20, 1968).

(b) *Consent to sale*—(1) *In general.* Notwithstanding the notice of sale provisions of paragraph (a) of this section, a nonjudicial sale of property shall discharge or divest the property of the lien or title of the United States if the district director for the internal revenue district in which the sale occurs consents to the sale of the property free of the lien or title. Pursuant to section 7425(c)(2), where adequate protection is afforded the lien or title of the United States, a district director may, in his discretion, consent with respect to the sale of property in appropriate cases. Such consent shall be effective only if given in writing and shall be subject to such limitations and conditions as the district director may require. However, a district director may not consent to a sale of property under this section after the date of sale, as determined under paragraph (b) of § 301.7425-2. For provisions relating to the authority of the district director to release a lien or discharge property subject to a tax lien, see sec-

tion 6325 and the regulations thereunder.

(2) *Application for consent.* Any person desiring a district director's consent to sell property free of a tax lien or a title derived from the enforcement of a tax lien of the United States in the property shall submit to the district director for the internal revenue district in which the sale is to occur a written application, in triplicate, declaring that it is made under penalties of perjury, and requesting that such consent be given. The application shall contain the information required in the case of a notice of sale, as set forth in paragraph (d)(1) of this section, and, in addition, shall contain a statement of the reasons why the consent is desired.

(c) *Sale of perishable goods*—(1) *In general.* A notice (as described in paragraph (d) of this section) of a nonjudicial sale of perishable goods (as defined in subparagraph (2) of this paragraph) shall be given in writing, by registered or certified mail or delivered by personal service, at any time before the sale, to the district director (marked for the attention of the chief, special procedures staff) for the internal revenue district in which the sale is to be conducted. Thus, under this section, a notice of sale is not effective if it is given to a district director other than the district director for the internal revenue district in which the sale is to be conducted. If a notice of a nonjudicial sale is timely given in the manner described in this paragraph, the nonjudicial sale shall discharge or divest the tax lien, or a title derived from the enforcement of a tax lien, of the United States in the property. The provisions of section 7502 (relating to timely mailing treated as timely filing) and 7503 (relating to time for performance of acts where the last day falls on Saturday, Sunday, or a legal holiday) apply in the case of notices required to be made under this paragraph. The seller of the perishable goods shall hold the proceeds (exclusive of costs) of the sale as a fund, for not less than 30 days after the date of the sale, subject to the liens and claims of the United States, in the same manner and with the same priority as the liens and claims of the United States had with respect to the property sold. If the seller fails to hold the proceeds of the sale in accordance with the provisions of this paragraph and if the district director asserts a claim to the proceeds within 30 days after the date of sale, the seller shall be personally liable to the United States for an amount equal to the value of the interest of the United States in the fund. However, even if the proceeds of the sale are not so held by the seller, but all the other provisions of this paragraph are satisfied, the buyer of the property at the sale takes the property free of the liens and claims of the United States. In the event of a postponement of the scheduled sale of perishable goods, the seller is not required to notify the district director of the postponement. For provisions relating to the authority of the district director to release a lien or discharge property subject to a tax lien, see section 6325 and the regulations thereunder.

(2) *Definition of perishable goods.* For the purpose of this paragraph, the term "perishable goods" means any tangible personal property which, in the reasonable view of the person selling the property, is liable to perish or become greatly reduced in price or value by keeping, or cannot be kept without great expense.

(d) *Content of notice of sale*—(1) *In general.* With respect to a notice of sale described in paragraph (a) or (c) of this section, the notice will be considered adequate if it contains the information described in subdivisions (i), (ii), (iii), and (iv) of this subparagraph.

(i) The name and address of the person submitting the notice of sale;

(ii) A copy of each Notice of Federal Tax Lien (Form 668) affecting the property to be sold, or the following information as shown on each such Notice of Federal Tax Lien—

(A) The internal revenue district named thereon,

(B) The name and address of the taxpayer, and

(C) The date and place of filing of the notice;

(iii) With respect to the property to be sold, the following information—

(A) A detailed description, including location, of the property affected by the notice (in the case of real property, the street address, city, and State and the legal description contained in the title or deed to the property and, if available, a copy of the abstract of title),

(B) The date, time, place, and terms of the proposed sale of the property, and

(C) In the case of a sale of perishable property described in paragraph (c) of this section, a statement of the reasons why the property is believed to be perishable; and

(iv) The approximate amount of the principal obligation, including interest, secured by the lien sought to be enforced and a description of the other expenses (such as legal expenses, selling costs, etc.) which may be charged against the sale proceeds.

(2) *Inadequate notice.* Except as otherwise provided in this subparagraph, a notice of sale described in paragraph (a) of this section which does not contain the information described in subparagraph (1) of this paragraph shall be considered inadequate by a district director. If a district director determines that the notice is inadequate, he will give written notification of the items of information which are inadequate to the person who submitted the notice. A notice of sale which does not contain the name and address of the person submitting such notice shall be considered to be inadequate for all purposes without notification of any specific inadequacy. In any case where a notice of sale,

given after December 31, 1976, does not contain the information required under subdivision (ii) of subparagraph (1) of this paragraph with respect to a Notice of Federal Tax Lien, the district director may give written notification of such omission without specification of any other inadequacy and such notice of sale shall be considered inadequate for all purposes. In the event the district director gives notification that the notice of sale is inadequate, a notice complying with the provisions of this section (including the requirement that the notice be given not less than 25 days prior to the sale in the case of a notice described in paragraph (a) of this section) must be given. However, in accordance with the provisions of paragraph (b)(1) of this section, in such a case the district director may, in his discretion, consent to the sale of the property free of the lien or title of the United States even though notice of the sale is given less than 25 days prior to the sale. In any case where the person who submitted a timely notice which indicates his name and address does not receive, more than 5 days prior to the date of the sale, written notification from the district director that the notice is inadequate, the notice shall be considered adequate for purposes of this section.

(3) *Acknowledgement of notice.* If a notice of sale described in paragraph (a) or (c) of this section is submitted in duplicate to the district director with a written request that receipt of the notice be acknowledged and returned to the person giving the notice, this request will be honored by the district director. The acknowledgement by the district director will indicate the date and time of the receipt of the notice.

(4) *Disclosure of adequacy of notice.* The district director for the internal revenue district in which the sale was held or is to be held is authorized to disclose, to any person who has a proper interest, whether an adequate notice of sale was given under subparagraph (1) of this paragraph. Any person desiring this information should submit to the district director a written request which clearly describes the property sold or to be sold, identifies the applicable notice of lien, gives the reasons for requesting the information, and states the name and address of the person making the request.

§ 301.7425-4 Discharge of liens; redemption by United States.

(a) *Right to redeem*—(1) *In general.* In the case of a nonjudicial sale of real property to satisfy a lien prior to the tax lien or a title derived from the enforcement of a tax lien, the district director may redeem the property within the redemption period (as described in subparagraph (2) of this paragraph). The right of redemption of the United States exists under section 7425(d) even though the district director has consented to the sale under section 7425(c)(2) and § 301.7425-3 (b). For purposes of this section, the term "nonjudicial sale" shall have the same meaning as used in paragraph (a) of § 301.7425-2.

(2) *Redemption period.* For purposes of this section, the redemption period shall be—

(i) The period beginning with the date of the sale (as determined under paragraph (b) of § 301.7425-2) and ending with the 120th day after such date, or

(ii) The period for redemption of real property allowable, with respect to other secured creditors, under the local law of the place where the real property is located,

whichever expires later. Whichever period is applicable, section 7425 and this section shall govern the amount to be paid and the procedure to be followed.

(3) *Limitations.* In the event a sale does not ultimately discharge the property from the tax lien (whether by reason of local law or the provisions of section 7425(b)), the provisions of this section do not apply because the tax lien will continue to attach to the property after the sale. In a case in which the Internal Revenue Service is not entitled to a notice of sale under section 7425(b) and § 301.7425-3, the United States does not have a right of redemption under section 7425(d). However, in such a case, if a tax lien has attached to the property at the time of sale, the United States has the same right of redemption, if any, which is afforded similar creditors under the local law of the place in which the property is situated.

(b) *Amount to be paid*—(1) *In general.* In any case in which a district director exercises the right to redeem real property under section 7425(d), the amount to be paid is the sum of the following amounts—

(i) The actual amount paid for the property (as determined under subparagraph (2) of this paragraph) being redeemed (which, in the case of a purchaser who is the holder of the lien being foreclosed, shall include the amount of the obligation secured by such lien to the extent legally satisfied by reason of the sale);

(ii) Interest on the amount paid (described in subdivision (i) of this subparagraph) at the sale by the purchaser of the real property computed at the rate of 6 percent per annum for the period from the date of the sale (as determined under paragraph (b) of § 301.7425-2) to the date of redemption;

(iii) The amount, if any, equal to the excess of (A) the expenses necessarily incurred to maintain such property (as determined under subparagraph (3) of this paragraph) by the purchaser (and his successor in interest, if any) over (B) the income from such property realized by the purchaser (and his successor in interest, if any) plus a reasonable rental value of such property (to the extent the property is used by or with the consent of the purchaser or his successor in interest or is

rented at less than its reasonable rental value); and

(iv) With respect to a redemption made after December 31, 1976, the amount, if any, of a payment made by the purchaser or his successor in interest after the foreclosure sale to a holder of a senior lien (to the extent provided under subparagraph (4) of this paragraph).

(2) *Actual amount paid.* (i) The actual amount paid for property by a purchaser, other than the holder of the lien being foreclosed, is the amount paid by him at the sale. For purposes of this subdivision, the amount paid by the purchaser at the sale includes deferred payments upon the bid price. The actual amount paid does not include costs and expenses incurred prior to the foreclosure sale by the purchaser except to the extent such expenses are included in the amount bid and paid for the property. For example, the actual amount paid does not normally include the expenses of the purchaser such as title searches, professional fees, or interest on debt incurred to obtain funds to purchase the property.

(ii) In the case of a purchaser who is the holder of the lien being foreclosed, the actual amount paid is the sum of (A) the amount of the obligation secured by such lien to the extent legally satisfied by reason of the sale and (B) any additional amount bid and paid at the sale. For purposes of this section, a purchaser who acquires title as a result of a nonjudicial foreclosure sale is treated as the holder of the lien being foreclosed if a lien (or any interest reserved, created, or conveyed as security for the payment of a debt or fulfillment of other obligation) held by him is partially or fully satisfied by reason of the foreclosure sale. For example, a person whose title is derived from a tax deed issued under local law shall be treated as a purchaser who is the holder of the lien foreclosed in a case where a tax certificate, evidencing a lien on the property arising from the payment of property taxes, ripens into title. The amount paid by a purchaser at the sale includes deferred payments upon any portion of the bid price which is in excess of the amount of the lien being foreclosed. The actual amount paid does not include costs and expenses incurred prior to the foreclosure sale by the purchaser except to the extent such expenses are included in the amount of the lien being foreclosed which is legally satisfied by reason of the sale or in the amount bid and paid at the sale. Where the lien being foreclosed attaches to other property not subject to the foreclosure sale, the amount legally satisfied by reason of the sale does not include the amount of such lien that attaches to the other property. However, for purposes of the preceding sentence, the amount of the lien that attaches to the other property shall be considered to be equal to the amount by which the value of the other property exceeds the amount of any other senior lien on that property. Where, after the sale, the holder of the lien being foreclosed has the right to the unpaid balance of the amount due him, the amount legally satisfied by reason of the sale does not include the amount of such lien to the extent a deficiency judgment may be obtained therefor. However, for purposes of the preceding sentence, an amount, with respect to which the holder of the lien being foreclosed would otherwise have a right to a deficiency judgment, shall be considered to be legally satisfied by reason of the foreclosure sale to the extent that the holder has waived his right to a deficiency judgment prior to the foreclosure sale. For this purpose, the waiver must be in writing and legally binding upon the foreclosing lienholder as of the time the sale is concluded. If, prior to the foreclosure, payments have been made by the foreclosing lienholder to a holder of a superior lien, the payments are included in the actual amount paid to the extent they give rise to an interest which is legally satisfied by reason of the foreclosure sale.

(3) *Excess expenses incurred by purchaser.* (i) Expenses necessarily incurred in connection with the property after the foreclosure sale and before redemption by the United States are taken into account in determining if there are excess expenses payable under subparagraph (1)(iii) of this paragraph. Expenses incurred by the purchaser prior to the foreclosure sale are not considered under this subparagraph. (See subparagraph (2)(ii) of this paragraph for circumstances under which such expenses may be included in the amount to be paid.) Expenses necessarily incurred in connection with the property include, for example, rental agent commissions, repair and maintenance expenses, utilities expenses, legal fees incurred after the foreclosure sale and prior to redemption in defending the title acquired through the foreclosure sale, and a proportionate amount of casualty insurance premiums and ad valorem taxes. Improvements made to the property are not considered as an expense unless the amounts incurred for such improvements are necessarily incurred to maintain the property.

(ii) At any time prior to the expiration of the redemption period applicable under paragraph (a)(2) of this section, the district director may, by certified or registered mail or hand delivery, request a written itemized statement of the amount claimed by the purchaser or his successor in interest to be payable under subparagraph (1)(iii) of this paragraph. Unless the purchaser or his successor in interest furnishes the written itemized statement within 15 days after the request is made by the district director, it shall be presumed that no amount is payable for expenses in excess of income and the Internal Revenue Service shall tender only the amount otherwise payable under subparagraph (1) of this paragarph. If

a purchaser or his successor in interest has failed to furnish the written itemized statement within 15 days after the request therefor is made by the district director, or there is a disagreement as to the amount properly payable under subparagraph (1)(iii) of this paragraph, a payment for excess expenses shall be made after the redemption within a reasonable time following the verification by the district director of a written itemized statement submitted by the purchaser or his successor in interest or the resolution of the disagreement as to the amount properly payable for excess expenses.

(4) *Payments made by purchaser or his successor in interest to a senior lienor.* (i) The amount to be paid upon a redemption by the United States made after December 31, 1976, shall include the amount of a payment made by the purchaser or his successor in interest to a holder of a senior lien to the extent a request for the reimbursement thereof (made in accordance with subdivision (ii) of this subparagraph) is approved as provided under subdivision (iii) of this subparagraph. This subparagraph applies only to a payment made after the foreclosure sale and before the redemption to a holder of a lien that was, immediately prior to the foreclosure sale, superior to the lien foreclosed. A payment of principal or interest to a senior lienor shall be taken into account. Generally, the portion, if any, of a payment which is to be held in escrow for the payment of an expense, such as hazard insurance or real property taxes, is not considered under this subparagraph. However, a payment by the escrow agent of a real property tax or special assessment lien, which was senior to the lien foreclosed, shall be considered to be a payment made by the purchaser or his successor in interest for purposes of this subparagraph. With respect to real property taxes assessed after the foreclosure sale, see subparagraph (3)(i) of this paragraph, relating to excess expenses incurred by the purchaser.

(ii) Before the expiration of the redemption period applicable under paragraph (a)(2) of this section, the district director shall, in any case where a redemption is contemplated, send notice to the purchaser (or his successor in interest of record) by certified or registered mail or hand delivery of his right under this subparagraph to request reimbursement (payable in the event the right to redeem under section 7425(d) is exercised) for a payment made to a senior lienor. No later than 15 days after the notice from the district director is sent, the request for reimbusement shall be mailed or delivered to the office specified in such notice and shall consist of—

(A) A written itemized statement, signed by the claimant, of the amount claimed with respect to a payment made to a senior lienor, together with the supporting evidence requested in the notice from the district director, and

(B) A waiver or other document that will be effective upon redemption by the United States to discharge the property from, or transfer to the United States, any interest in or lien on the property that may arise under local law with respect to the payment made to a senior lienor.

Upon a showing of reasonable cause, a district director may, in his discretion and at any time before the expiration of the applicable period for redemption, grant an extension for a reasonable period of time to submit, amend, or supplement a request for reimbursement. Unless a request for reimbursement is timely submitted (determined with regard to any extension of time granted), no amount shall be payable to the purchaser or his successor in interest on account of a payment made to a senior lienor if the right to redeem under section 7425(d) is exercised. A waiver or other document submitted pursuant to this subdivision shall be treated as effective only to the extent of the amount included in the redemption price under this subparagraph. If the right to redeem is not exercised or a request for reimbursement is withdrawn, the district director shall, by certified or registered mail or hand delivery, return to the purchaser or his successor any waiver or other document submitted pursuant to this subdivision as soon as is practicable.

(iii) A request for reimbursement submitted in accordance with subdivision (ii) of this subparagraph shall be considered to be approved for the total amount claimed by the purchaser, and payable in the event the right to redeem is exercised, unless the district director sends notice to the claimant, by certified or registered mail or hand delivery, of the denial of the amount claimed within 30 days after receipt of the request or 15 days before expiration of the applicable period for redemption, whichever is later. The notification of denial shall state the grounds for denial. If such notice of denial is given, the request for reimbursement for a payment made to a senior lienor shall be treated as having been withdrawn by the purchaser or his successor and the Internal Revenue Service shall tender only the amount otherwise payable under subparagraph (1) of this paragraph. If a request for reimbursement is treated as having been withdrawn under the preceding sentence, payment for amounts described in this subparagraph may, in the discretion of the district director, be made after the redemption upon the resolution of the disagreement as to the amount properly payable under subparagraph (1)(iv) of this paragraph.

(5) *Examples.* The provisions of subparagraph (1)(i) of this paragraph may be illustrated by the following examples:

Example (1). A, a delinquent taxpayer, owns Blackacre located in State X upon which B holds a mortgage. After the mort-

gage is properly recorded, a notice of tax lien is filed under section 6323(f) which is applicable to Blackacre. Subsequently, A defaults on the mortgage and B forecloses on the mortgage which has an outstanding obligation in the amount of $100,000. At the foreclosure sale, B bids $50,000 and obtains title to Blackacre as a result of the sale. At the time of the foreclosure sale, Blackacre has a fair market value of $75,000. Under the laws of State X, the mortgage obligation is fully satisfied by operation of the foreclosure sale per se and the mortgagee cannot obtain a deficiency judgment. Under subparagraph (1)(i) of this paragraph, the district director must pay $100,000 in order to redeem Blackacre.

Example (2). Assume the same facts as in example (1) except that under the laws of State X, the amount bid is the amount of the obligation legally satisfied as a result of the foreclosure sale, and in the case in which the amount of the obligation exceeds the amount bid, the mortgagee has the right to a judgment for the deficiency computed as the difference between the amount of the obligation and the amount bid. B does not waive, prior to the foreclosure sale, his right to a deficiency judgment. In such a case, the district director must, under supbaragraph (1)(i) of this paragraph, pay $50,000 in order to redeem Blackacre, whether or not B seeks a judgment for the deficiency.

Example (3). C, a delinquent taxpayer, owns Greenacre located in State Y upon which D holds a first mortgage and E holds a second mortgage. After the mortgages are properly recorded, a notice of tax lien is filed under section 6323(f) which is applicable to Greenacre. Subsequently, C defaults on both mortgages and E pays $5,000 to D, which is the portion of D's obligation which is in default. The second mortgage held by E is an outstanding obligation in the amount of $100,000. Under the laws of State Y, E may treat the amount paid to D as an addition to his second mortgage upon foreclosure by him. E forecloses upon the security interest held by him. At the foreclosure sale, E bids $50,000 and obtains title to Greenacre subject to D's mortgage as a result of the foreclosure sale. Under the laws of State Y, the mortgage obligation legally satisfied is the amount bid and E has the right to a judgment for a deficiency in the amount of $55,000 ($100,000 plus $5,000 less $50,000). In such a case, the district director must, under subparagraph (1)(i) of this paragraph, pay $50,000 in order to redeem Greenacre, whether or not E seeks a judgment for the deficiency.

Example (4). The law of State Z contains a procedure which permits a county to collect a delinquent tax assessment with respect to real property by the means of a "tax sale" of the property. Pursuant to this procedure, a public auction is conducted on January 15, 1970, to collect the delinquent property taxes assessed against Whiteacre, which is owned by F. At the auction, a bid of $1,000 (representing the tax, costs, and interest due at the time of the auction) is made by G. Subsequently, G pays the amount bid to the county and obtains a tax certificate with respect to Whiteacre. Under this tax sale procedure, the obtaining of the tax certificate does not directly result in the divestment of either F's title or any junior liens on Whiteacre. On January 15, 1973, the period under this tax sale procedure during which F could have redeemed Whiteacre expires. Further, more than 30 days before January 15, 1973, a notice of tax lien affecting Whiteacre is filed under section 6323(f) with respect to F's delinquent Federal income taxes. Under the state tax sale procedure, the amount which would be required to be paid by F to G on January 15, 1973, to redeem Whiteacre is $1,350 (the $1,000 amount bid, interest of $300, and costs of $50). However, Whiteacre is not redeemed by F under the state procedure and, on January 16, 1973, G obtains a tax deed to Whiteacre. Under the law of State Z, the issuance of the tax deed results in the divestment of F's title and junior liens on Whiteacre. Thus, under § 301.7425-2(b), the date of sale is January 16, 1973, for purposes of section 7425(b). The amount legally satisfied by reason of the sale is the amount G is entitled to receive, immediately prior to the expiration of the period for redemption under the law of State Z, if Whiteacre were redeemed at such time. Thus, the district director must, under subparagraph (1)(i) of this paragraph pay $1,350 in order to redeem Whiteacre.

(c) *Certificate of redemption*—(1) *In general.* If a district director exercises the right of redemption of the United States described in paragraph (a) of this section, he shall apply to the officer designated by local law, if any, for the documents necessary to evidence the fact of redemption and to record title to the redeemed property in the name of the United States. If no such officer has been designated by local law or if the officer designated by local law fails to issue the necessary documents, the district director is authorized to issue a certificate of redemption for the property redeemed by the United States.

(2) *Filing.* The district director shall, without delay, cause either the documents issued by the local officer or the certificate of redemption executed by the district director to be filed with the local office where certificates of redemption are generally filed. If a certificate of redemption is issued by the district director and if the State in which the real property redeemed by the United States is situated has no office with which certificates of redemption may be filed, the district director shall file the certificate of redemption in the office of the clerk of the United States district court for the judicial district in which the redeemed property is situated.

(3) *Effect of certificate of redemption.* A certificate of redemption executed pursuant to subparagraph (1) of this paragraph shall constitute *prima facie* evidence of the regularity of the redemption. When a certificate of redemption is recorded, it shall transfer to the United States all the rights, title, and interest in and to the redeemed property acquired by the person, from whom the district director redeemed the property, by virtue of the sale of the property. Therefore, if under local law the purchaser takes title free of liens junior to the lien of the foreclosing lienholder, the United States takes title free of such junior liens upon redemption of the property. If a certificate of redemption has been erroneously prepared and filed because the redemption was not effective, the district director shall issue a document revoking such certificate of redemption and such document shall be conclusively binding upon the United States against a purchaser of the property or a holder of a lien upon the property.

(4) *Application for release of right of redemption.* Upon application of a party with a proper interest in the real property sold in a nonjudicial sale described in section 7425(b) and § 301.7425-2 which real property is subject to the right of redemption of the United States described in this section, the district director may, in his discretion, release the right of redemption with respect to the property. The application for the release shall be submitted in writing to a district director and shall contain such information as

the district director may require. If the district director determines that the right of redemption of the United States is without value, no amount shall be required to be paid with respect to the release of the right of redemption.

(This Treasury decision is issued under the authority contained in 7805 of the Internal Revenue Code of 1954. (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved August 16, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 19, 1976; 8:45 a.m., and published in the issue of the Federal Register for August 20, 1976, 41 F.R. 35174)

Subtitle D.—Miscellaneous Excise Taxes
Chapter 31.—Retailers Excise Taxes
Subchapter E.—Special Fuels

Section 4041.—Imposition of Tax

26 CFR 154.1-1: Tax-free sales and purchases of fuel under section 4041(c); registration.
(Also Sections 4261, 4271; 49.4261-1, 154.2-1.)

Aircraft owned and operated for exclusive use of corporation's shareholders. A corporation that employs a full-time pilot to fly an aircraft which it owns and maintains for use exclusively by its shareholders, each of whom establish the schedule and destinations of flights and is charged an amount for flight service based either on an hourly rate or on the number of miles flown, is engaged in selling transportation services and is subject to the taxes imposed by sections 4261(a) and 4271(a) rather than section 4041(c) of the Code.

Rev. Rul. 76-431

Advice has been requested as to the applicability of the excise tax provisions of the Internal Revenue Code of 1954 under the circumstances described below. The specific questions relate to the application of the tax on aviation fuel imposed by section 4041 (c) or, alternatively, the taxes on the transportation of persons and property imposed by sections 4261 and 4271.

A group of individuals organized a corporation to acquire, operate, and maintain an executive aircraft for use exclusively by such individuals in their business and personal interests within the United States. The individuals are the sole shareholders of the corporation. The aircraft has a maximum certificated takeoff weight in excess of 6,000 pounds, and a full-time pilot is employed by the corporation to fly the aircraft.

Each shareholder is charged an amount for flight service based either on an hourly rate or on the number of miles flown. These rates are calculated to cover all costs of operation.

With respect to any given flight, the shareholder using the aircraft establishes the schedule and destination, but the pilot is recognized as having primary authority for the safety and actual operation of the aircraft. From time to time business-related persons are transported without charge when they accompany a shareholder on a flight.

Section 4041(c) of the Code imposes a tax on gasoline and any other liquid either (1) sold by any person to an owner, lessee, or other operator of an aircraft, for use as a fuel in such aircraft in noncommercial aviation, or (2) used by any person as a fuel in an aircraft in noncommercial aviation, unless there was a taxable sale of such liquid under this section. Under the provisions of section 4041(c)(4), the term "noncommercial aviation" means any use of aircraft other than use in a business of transporting persons or property by air for compensation or hire.

Section 4261(a) of the Code imposes a tax upon amounts paid for the taxable transportation of any person by air.

Section 4271(a) of the Code imposes a tax upon amounts paid for the taxable transportation of property by air.

Rev. Rul. 60-311, 1960-2 C.B. 341, states that where the owner of a vehicle (such as a helicopter) leases it to others for the transportation of persons but retains the elements of possession, command, and control of the vehicle and performs all services in connection with the operation of the vehicle, the owner is furnishing a taxable transportation service within the meaning of section 4261 of the Code.

Rev. Rul. 76-394, page 355, this Bulletin, holds that where a parent company has the elements of possession, command, and control of a plane at all times, amounts paid by a wholly-owned subsidiary and other related companies to the parent company under an expense sharing plan are amounts paid for transportation service, even though the subsidiary and other companies may direct the pilot as to destination and other details concerning flights when they are using the plane.

Inasmuch as the corporation in the instant case owns and maintains the aircraft and employs a full-time pilot, the corporation retains the elements of possession, command, and control of the aircraft even though the users may establish the schedule and destinations of flights. Since the corporation retains these elements, the fact that the corporation is providing the aircraft and pilot for the use of its shareholders rather than for the use of unrelated parties is not material for purposes of this ruling.

The corporation is engaged in selling services (transportation) for compensation rather than in noncommercial aviation. Therefore, the use of the aircraft is within the scope of sections 4261(a) and 4271(a) of the Code rather than of section 4041(c). Accordingly, the taxes imposed by sec-

tions 4261(a) and 4271(a) apply to the amounts paid to the corporation by the shareholders for flight service.

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26 CFR 154.1-1: Tax-free sales and purchases of fuel under section 4041(c); registration.
(Also Sections 4261, 4271; 49.4261-1, 154.2-1.)

Transportation and aviation fuel taxes; helicopters under contract to Federal agency. A contractor providing and controlling the pilots, maintenance, and fuel for helicopters provided to a Federal agency for its administrative activities and for forest fire detection, reconnaisance, and suppression is furnishing transportation services taxable under section 4261 or 4271 of the Code when transporting agency personnel or property. However, the tax imposed on aviation fuel by section 4041(c) applies to helicopter use for the agency with only the contractor's employees aboard, such as flights to spot fires or drop fire retardant chemicals.

Rev. Rul. 76-477

Advice has been requested as to the applicability, under the circumstances described below, of the taxes on aviation fuel and transportation of persons and property imposed by sections 4041(c), 4261, and 4271 of the Internal Revenue Code of 1954, respectively.

Under a contract with a Federal agency, an aviation company provides helicopters to be used for administrative flying, fire detection, fire reconnaissance, and fire suppression at public land forest locations. The aviation company furnishes pilots, maintenance crews, service trucks, and fuel. The contract requires that the helicopters and pilots be readily available at designated bases for seven days per week during the fire season and for intermittent use thereafter.

The contract provides that the helicopters remain in the custody of the aviation company. The agency determines the acceptability of the pilots and aircraft, and the aircraft, service trucks, and maintenance crews must meet the specifications of the contract. The pilot is free to refuse any flight or landing the pilot considers hazardous or unsafe and is responsible for determining the safe gross weight of the helicopter. The aviation company is liable for loss or damages arising out of its performance of the contract.

Under the contract the agency provides certain equipment for the helicopters including a helitank, bucket, or bag to carry water or fire retardant chemicals that are released over fires by the pilot of the helicopter, an air to ground audio communication system, and radios. Agency personnel are not carried aboard helicopters used to release water or chemicals over fires. An agency control officer directs each flight and instructs the pilot as to the services required, destination, and course. Each helicopter has a maximum certificated gross weight in excess of 6,000 pounds.

Section 4041(c) of the Code imposes a tax on gasoline and any other liquid either (1) sold by any person to an owner, lessee, or other operator of an aircraft, for use as a fuel in such aircraft in noncommercial aviation, or (2) used by any person as a fuel in an aircraft in noncommercial aviation, unless there was a taxable sale of such liquid under this section. Under the provisions of section 4041(c)(4), the term "noncommercial aviation" means any use of aircraft other than use in a business of transporting persons or property by air for compensation or hire.

Section 4261(a) of the Code imposes a tax upon amounts paid for the taxable transportation of any person by air.

Section 4271(a) of the Code imposes a tax upon amounts paid for the transportation of property by air. The tax imposed by that section applies only to amounts paid to a person engaged in the business of transporting property by air for hire.

Rev. Rul. 60-311, 1960-2 C.B. 341, states that where the owner of a vehicle (such as a helicopter) leases it to others for the transportation of persons but retains possession, command, and control of the vehicle, the owner is furnishing a taxable transportation service. However, where the owner of the vehicle transfers the complete possession, command, and control of its vehicle to a lessee, either by a charter-party or by actual practice, the owner is not engaging in a taxable transportation service but is merely leasing its vehicle.

Rev. Rul. 76-394, page 355, this Bulletin, holds that where a parent company has the elements of possession, command, and control of a plane at all times, amounts paid by a wholly-owned subsidiary and other related companies to the parent company under an expense sharing plan are amounts paid for transportation service, even though the subsidiary and other companies may direct the pilot as to destination and other details concerning flights when they are using the plane.

Rev. Rul. 72-156, 1972-1 C.B. 331, holds that sales of aviation fuel for use in aircraft providing firefighting protection service, involving the hauling and dropping of fire retardant with only air tanker company personnel on board, are subject to the tax imposed by section 4041(c) of the Code, and the taxes imposed by sections 4261 and 4271 are not applicable in that situation. That Revenue Ruling states that either the transportation taxes or the fuel taxes apply to any one use of an aircraft. Further, where there is a possibility of either the transportation taxes or fuel taxes applying, it is necessary to determine on a flight-by-flight basis whether the aircraft involved is being used in a business of transporting persons or property for compensation or hire so as to be subject to the transportation taxes, rather than the fuel taxes.

In the instant case, the aviation company provides the elements necessary for the transportation of persons and property, including the aircraft, pilots, maintenance crews and facilities, and fuel. In addition, the pilot may refuse flights the pilot considers unsafe or hazardous, the aviation company is responsible for loss or damages arising out of its performance of the contract, and the company retains custody of the aircraft.

Although the agency maintains certain controls over the quality and activities of helicopters, pilots, maintenance crews and facilities that are provided, such elements are fundamentally under the possession, command, and control of the aviation company. Thus, the aviation company is furnishing transportation services to the agency for compensation within the scope of sections 4261 or 4271 of the Code when the helicopters are used to carry agency personnel or to transport property for the agency, respectively.

Accordingly, the taxes on the transportation of persons and property imposed by sections 4261(a) and 4271 (a) of the Code apply to amounts paid to the company by the agency for such services. On the other hand, when the helicopters are used with only aviation company employees aboard to perform such functions as spotting fires or hauling and dropping fire retardant chemicals, the tax imposed by section 4041(c) applies to aviation fuel sold for use or used in the helicopters furnishing such services. The determination as to which tax should apply must be made on a flight-by-flight basis.

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26 CFR 154.1-1: Tax-free sales and purchases of fuel under section 4041(c); registration.

Whether fuel is subject to tax when sold for use in aircraft having a maximum certificated takeoff weight of 6,000 pounds or less to transport persons for a per diem charge and a fixed hourly charge for actual flying time. See Rev. Rul. 76-556, page 354.

Subchapter F.—Special Provisions Applicable to Retailers Tax

Section 4055.—State and Local Government Exemption [Repealed by section 1904(a)(1)(D) of Public Law 94-455, effective February 1, 1977.]

(Also Section 4221, 4292.)

Exemptions; irrigation districts; California. Irrigation districts formed under California law and specifically declared to be state agencies formed and existing for governmental purposes come within the scope of the exemptions provided with respect to State or political subdivisions; however, the Federal excise exemptions do not apply to amounts paid for air transportation. Rev. Rul. 57-254 superseded.

Rev. Rul. 76-549

The purpose of this Revenue Ruling is to update and restate under the current statutes the conclusions set forth in Rev. Rul. 57-254, 1957-1 C.B. 383. That Revenue Ruling relates to whether irrigation districts in the State of California come within the scope of the Federal excise tax exemptions provided by sections 4055, 4221(a)(4), and 4292 of the Internal Revenue Code of 1954.

Irrigation districts in the State of California are formed pursuant to Division 11 of the Water Code of California. They are specifically declared to be state agencies formed and existing for governmental purposes. The statutes provide in detail for the formation and administration of irrigation districts, which are managed and operated by boards of directors.

Irrigation districts are under the general supervision of the Department of Public Works, the powers and duties of which are exercised through the State Engineer. They are under the more specific supervision of the county boards of supervisors, who are charged with the duty of conducting the hearings and elections that result in the formation of the districts and who are responsible for seeing that the duties and functions of the officers and boards of directors of the districts are carried out.

The irrigation districts are required by statute (except where all funds required are raised otherwise than by assessment) to levy assessments on the land within the districts for the purpose of paying their expenses and discharging their obligations. If the district board or any of its officers neglects or refuses to levy assessments or carry out any of the duties required by statute, the county board of supervisors may remove such official or perform the required duties in his stead in the same manner and with the same effect as if they were done by the duly constituted official.

Any money belonging to a district may be deposited in accordance with the general laws governing the deposit of public money. Any amount in excess of $25,000 in the construction fund of an irrigation district may be deposited in the county treasury and withdrawn from time to time.

The districts possess the right of eminent domain to acquire water and property deemed necessary to carry out the purposes for which the districts are formed.

Section 4055 of the Code provides that, under regulations prescribed by the Secretary of the Treasury or his delegate, the retailers excise taxes will not apply to the sale of any article for the exclusive use of any State, Territory of the United States, or any political subdivision of any of the foregoing, or the District of Columbia, or with respect to the use by any of the foregoing of any liquid as a fuel.

Section 4221(a)(4) of the Code provides that, under regulations prescribed by the Secretary or his delegate, the manufacturers excise taxes will not apply to the sale by the manufacturer of an article to a State

or local government for the exclusive use of a State or local government.

Section 4292 of the Code provides that, under regulations prescribed by the Secretary or his delegate, no tax shall be imposed under section 4251 upon any payment received for communication services or facilities furnished to the Government of any State, Territory of the United States, or any political subdivision of the foregoing, or the District of Columbia.

Section 205(a)(2) of the Airport and Airway Revenue Act of 1970, Pub. L. 91-258, 1970-1 C.B. 361, 363, removed the State and local governmental exemptions from the air transportation of persons tax effective July 1, 1970.

The irrigation districts formed pursuant to Division 11 of the Water Code of California come within the scope of the exemptions provided by (1) section 4055 of the Code, relating to the retailers excise taxes, (2) section 4221(a)(4), relating to the manufacturers excise taxes, and (3) section 4292, relating to the taxes on communication services or facilities. Accordingly, where taxable articles are sold to the irrigation districts for their exclusive use or where communication services and facilities are furnished to the districts, the excise tax exemptions will apply, provided the requirements of the law and applicable regulations with respect to the particular exemption are met.

However, the Federal excise tax exemptions provided for States and political subdivisions no longer apply to the amounts paid for transportation by air that began after June 30, 1970, because exemption was withdrawn by the Airport and Airway Revenue Act.

Rev. Rul. 57-254 is superseded since the position set forth therein is restated under current law in this Revenue Ruling.

(Also Sections 4221, 4261, 4271, 4292; 26 CFR 148.1-3, 154.2-1.)

Exemptions; municipal associations. Municipal associations composed of towns and cities of their respective states and organized exclusively for public purposes come within the scope of the exemption from retailers, manufacturers, and communications taxes but are subject to the tax on air transportation; Rev. Rul. 58-156 superseded.

Rev. Rul. 76-550

The purpose of this Revenue Ruling is to update and restate under current statutes the conclusion set forth in Rev. Rul. 58-156, 1958-1 C.B. 389. Rev. Rul. 58-156 is concerned with whether certain State associations of municipalities some within the scope of the Federal excise tax exemptions provided by sections 4055, 4224 (now 4221(a)(4)), and 4292 of the Internal Revenue Code of 1954.

Many State associations of municipalities are voluntary nonprofit organizations organized by city officials for exclusively public purposes to identify, promote, and serve the needs and best interests of the towns and cities of their respective States. They promote and sponsor research and training for municipal officials and employees. They provide information and materials to increase the efficiency of municipal governments, and provide a voice and representation before State legislatures and the United States Congress.

The only voting members are the towns and cities, and each has one vote through the official representing that town or city. There may be other classes of membership established by the board of directors such as (1) selected honorary membership for distinguished persons and (2) associate membership for those interested in the furtherance of the association's objectives. An insignificant amount of the association's operating funds come from associate membership annual dues. The remainder of the operating funds come from annual dues paid by the member towns and cities, which dues are fixed within maximum and minimum amounts, based upon the populations of the towns and cities.

Section 4055 of the Code provides that the retailers excise taxes will not apply to the sale of any article for the exclusive use of any State, Territory of the United States, or any political subdivision of any of the foregoing, or the District of Columbia, or with respect to the use by any of the foregoing of any liquid as a fuel.

Section 4221(a)(4) of the Code provides that the manufacturers excise taxes will not apply to the sale by the manufacturer of an article to a State or local government for the exclusive use of a State or local government.

Section 4292 of the Code provides that no tax shall be imposed under section 4251 upon any payment received for communications services or facilities furnished to the Government of any State, Territory of the United States, or any political subdivision of the foregoing, or the District of Columbia.

Section 205(a)(2) of the Airport and Airway Revenue Act of 1970, Public Law 91-258, 1970-1 C.B. 361, 363, removed the State and local government exemption relating to the air transportation of persons tax, effective July 1, 1970.

Based on the facts set forth above, it it concluded that these State associations come within the scope of the exemptions provided by (1) section 4055 of the Code, relating to the retailers excise taxes, (2) section 4221(a)(4), relating to the manufacturers excise taxes, and (3) section 4292, relating to the taxes on communications services or facilities. Thus, where taxable articles are sold to the associations for their exclusive use or where communications services and facilities are furnished to them, the excise tax exemptions will apply.

Effective February 1, 1977, under section 1904 of the Tax Reform Act of 1976, the exemptions provided by

sections 4055 and 4292 of the Code are under new sections 4041(g)(2) and 4253(i), respectively.

The Federal excise tax exemptions provided for States and political subdivisions thereof no longer apply to the taxes on amounts paid for transportation.

Therefore, the associations are subject to the taxes under sections 4261 and 4271 of the Code on amounts paid for transportation of persons or property.

Rev. Rul. 58-156 is superseded because the position set forth therein is restated under current law in this Revenue Ruling.

Whether a state university flying club comes within the scope of the retailers excise tax exemption. See Rev. Rul. 76-509, page 349.

Chapter 32.—Manufacturers Excise Taxes
Subchapter A.—Automotive and Related Items
Part I.—Motor Vehicles

Section 4061.—Imposition of Tax

Whether buses sold for use on a certain route are to be used predominantly in mass transportation service in urban areas for purposes of the exemption provided by section 4063(a)(6). See Rev. Rul. 76-285, page 343.

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26 CFR 48.4061(a)-1: Imposition of tax. (Also Section 4063.)

Farm dump truck body equipped for hay. A dump truck body specially designed and equipped to haul and stack hay and optional reloading equipment and side extensions increasing the load capacity, whether purchased with the body or separately, are exempt from tax under section 4063(a)(2) of the Code; however, steel sides, tailgate, and folding cattle racks are not exempt.

Rev. Rul. 76-254

Advice has been requested whether the manufacturers excise tax on motor vehicle articles imposed by section 4061(a)(1) of the Internal Revenue Code of 1954 applies to sales of a certain truck body and accessories, or whether that body or accessories are exempt from taxation under section 4063(a)(2).

A company manufactures and sells a body designed to be mounted on a truck chassis for use in hauling and stacking baled hay and for use as an all-purpose dump body. The body consists of a specially designed floor deck with a push off system including platforms, planks and guides, and subframe assembly. The subframe assembly reinforces the truck chassis and contains two hydraulic cylinders for hoisting the deck, two hydraulic cylinders for unloading baled hay, a hydraulic pump, valves, plumbing, and hoses.

When equipped by the manufacturer for hauling hay, the body includes side and rear stakes that can be adjusted for particular sizes of bales and a headboard extension that prevents bales from falling forward. The manufacturer sells, as optional equipment, extensions that attach to the side of the deck to accommodate additional bales of hay; a retrieving kit that makes it possible to reload hay back onto the body; steel sides and a swinging tailgate, with or without a small grain door, that enable the vehicle to be used for general purpose hauling; and a folding cattle rack that fits on the steel sides.

The body can be elevated until it is perpendicular to the chassis frame for ease in unloading and stacking hay. It has been specially designed so that several sections can be moved by hydraulic cylinders to slide the hay from the truck body to make a firm stack. The special features of this body, including its hay stacking equipment, add significantly to the cost of the body. In fact, the cost of the body is approximately three times the cost of a standard dump truck body.

Section 4061(a)(1) of the Code imposes a tax upon the sale by the manufacturer, producer, or importer of automobile truck bodies, including in each case parts or accessories therefor sold on or in connection therewith or with the sale thereof.

Section 4061(b)(1) of the Code imposes a tax on the sale by the manufacturer, producer, or importer of parts or accessories (other than tires and inner tubes) for any of the articles enumerated in section 4061(a)(1).

Section 4063(a)(2)(B) of the Code provides that the tax imposed by section 4061 shall not apply in the case of any body, part, or accessory primarily designed to haul feed, seed, or fertilizer to and on farms. Section 4063(a)(2)(D) provides that the tax imposed by section 4061 shall not apply in the case of any body, part, or accessory primarily designed to load or unload feed, seed, or fertilizer on farms.

Although the body described herein can be used as an all-purpose dump truck, it is primarily designed to haul hay, a feed, *to* and *on* farms. This is evidenced by the special design features of the body. These features indicate that the body, when used on the highway, is primarily designed to transport hay to a farm, and to unload hay on a farm. The additional cost of these bodies compared with the cost of conventional dump truck bodies also indicates that the bodies are primarily designed to haul feed to and on farms. See Rev. Rul. 69-579, 1969-2 C.B. 200, which holds that certain automotive bodies equipped with elaborate and expensive unloading systems are primarily designed to haul feed, seed, or fertilizer to and on farms within the meaning of section 4063(a)(2)(B) of the Code. The fact that the body can be used for other purposes will not preclude its exemption.

Accordingly, sales by the manufacturer of the body, equipped to haul hay and stack it, are exempt from the manufacturers excise tax imposed by section 4061(a)(1) of the Code under

the provisions of section 4063(a)(2). In addition, the accessory kit that makes it possible to reload hay back onto the body and the optional extensions that attach to the side of the body to accommodate additional bales of hay are also exempt from the tax imposed by section 4061(a)(1) when sold on or in connection with the body, and from the tax imposed on parts or accessories by section 4061(b)(1) when sold separately, since those articles are primarily designed for exempt purposes set forth in section 4063 (a)(2).

The steel sides and tailgate are not primarily designed to haul feed, seed or fertilizer to or on farms. They are designed to give the vehicle solid sides instead of stakes so it can be used for hauling cargo other than baled hay, that is, for general purpose hauling. The folding cattle rack is likewise not primarily designed for exempt purposes within the meaning of section 4063(a)(2) of the Code. All of these accessories are designed for use as automotive parts or accessories, and are taxable as such.

Section 4061(a)(1) of the Code provides that parts or accessories sold with a body are included in the sale price of the body that is subject to tax at the rate specified by that section, 10 percent. Section 4061(b)(1) provides that separate sales of parts or accessories are subject to tax at the rate specified therein, 8 percent. Since the body in this situation is exempt under section 4063(a)(2), the provisions of section 4061(a)(1) do not apply to the body or the steel sides, tailgate, and folding cattle rack sold therewith.

Parts or accessories are not necessarily exempt merely because they are sold with a body that is exempt. Since the steel sides, tailgate, and folding cattle rack do not perform functions related to the exempt purpose of the body, sales by the manufacturer of such articles are subject to the tax imposed by section 4061(b)(1) of the Code whether they are sold with the body or separately.

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26 CFR 48.4061(a)-1: Imposition of tax. (Also Section 4063.)

Farm semitrailer. A gooseneck-type dump semitrailer sold for use in hauling grain, seed, fertilizer, and livestock on the farm and over the highway, having axles, tires, lights, and equipment indicating it is primarily designed for highway use, and having no specific features indicating it is primarily designed to haul feed, seed, or fertilizer to and on farms is neither a farm wagon that is not a trailer within the meaning of section 4061(a) of the Code nor exempt under section 4063(a)(2)(B).

Rev. Rul. 76-361

Advice has been requested whether sales of a certain dump semitrailer are subject to the manufacturers excise tax imposed by section 4061(a)(1) of the Internal Revenue Code of 1954.

A company manufacturers and sells a gooseneck-type dump semitrailer for use in hauling grain, seed, fertilizer, and livestock on the farm and over the highway. The semitrailer has a gross vehicle weight in excess of 10,000 pounds and is designed to be towed by a pickup tuck or a farm tractor. The body has a bed 16 feet long, vented sides, and fold up stock racks. The semitrailer is equipped with two 7,500 pound rated torsion spring axles, four 10-ply 12 x 16.5 wide base tires with highway tread design, a hoist with an electric hydraulic pump, a 12 volt battery, brakes, and lights that meet Federal highway standards.

Section 4061(a)(1) of the Code imposes a tax on the sale by the manufacturer, producer, or importer of certain enumerated motor vehicle articles including truck trailer and semitrailer chassis and bodies.

Section 4063(a)(2)(B) of the Code provides that the tax imposed under section 4061 shall not apply in the case of any body, part or accessory primarily designed to haul feed, seed, or fertilizer to and on farms.

Section 48.4061(a)-1(e)(1) of the Manufacturers and Retailers Excise Tax Regulations provides that a trailer or semitrailer chassis or body primarily designed for highway use in combination with a taxable truck, bus, or tractor is subject to the tax imposed by section 4061(a)(1) of the Code. Section 48.4061(a)-1(e)(3) of the regulation provides that a farm wagon primarily designed for use on farms, although it may be used on the highway, illustrates a type of vehicle that is not a trailer within the meaning of section 4061(a).

The semitrailer in the instant case is capable of performing farm related functions normally associated with a farm wagon. However, the axles, tires, lights, etc., indicate that the semitrailer is primarily designed for highway use in combination with a truck. Therefore, it is not a farm wagon within the meaning of section 48.4061 (a)-1(e)(3) of the regulations.

The exemption from tax provided by section 4063(a)(2)(B) of the Code is limited to any body, part or accessory primarily designed to haul feed, seed, or fertilizer to and on farms.

Highway bodies that are used for the general hauling of feed, seed, or fertilizer over the highway are subject to the manufacturers excise tax unless they have specific features that indicate they are primarily designed to haul feed, seed, or fertilizer to and on farms. Rev. Rul. 75-462, 1975-2 C.B. 419.

The semitrailer body in the instant case is designed to haul various types of products on the farm and over the highway. Although seed and fertilizer are among such products, the body does not have specific features that indicate it is primarily designed to haul feed, seed, or fertilizer to and on farms.

Consequently, the body is not of the type contemplated by section 4063

(a)(2)(B) of the Code. Therefore, the exemption for feed, seed, or fertilizer equipment in section 4063(a)(2)(B) does not apply to sales of the body by the manufacturer.

Accordingly, sales by the manufacturer of the semitrailer are subject to the tax imposed by section 4061(a)(1) of the Code.

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26 CFR 48.4061(a)-1: Imposition of tax. (Also Section 4063.)

Horse semitrailer with living area. Gooseneck-type horse semitrailers that by special order are manufactured to include a self-contained living area in addition to the area for horses do not qualify for the exemption for house trailers provided by section 4063(a)(3) of the Code.

Rev. Rul. 76-432

Advice has been requested as to the application of the manufacturers excise tax on motor vehicle articles imposed by section 4061(a)(1) of the Internal Revenue Code of 1954 to sales of the semitrailers described below.

A company manufactures and sells 2-axled gooseneck horse semitrailers. In some instances, pursuant to a customer's order, the semitrailers are manufactured to include an area to transport two to four horses and, in addition, a self-contained living area. The incorporation of a living area requires the addition of a third axle to the semitrailer. The equipment installed in the living area includes beds, bathroom facilities, dinette, refrigerator, stove, and air conditioning. The semitrailers are designed to be towed by light duty trucks.

Section 4061(a)(1) of the Code imposes a tax on the sale by the manufacturer, producer, or importer of certain enumerated motor vehicle articles, including truck semitrailer chassis and bodies.

Section 4061(a)(2) of the Code provides that the tax imposed by section 4061(a)(1) does not apply to the sale by the manufacturer of articles suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less. Among such articles are truck semitrailer chassis and bodies suitable for use with a semitrailer having a gross vehicle weight of 10,000 pounds or less.

Section 4063(a)(3) of the Code provides that the tax imposed under section 4061(a) shall not apply in the case of house trailers.

Section 142.1-1(d)(3) of the Temporary Excise Tax Regulations under the Revenue Act of 1971 states that for purposes of the exclusion for light-duty trucks gross vehicle weight means the maximum total weight of a loaded vehicle.

The semitrailers in question are designed to transport horses and, in addition, provide living quarters. The inclusion of living quarters in a semitrailer that is designed to transport horses or other cargo does not qualify the semitrailer or the living quarters portion thereof for the exemption for house trailers provided by section 4063(a)(3) of the Code.

Therefore, sales by the manufacturer of the semitrailers described above that have a gross vehicle weight of more than 10,000 pounds are subject to the manufacturers excise tax imposed by section 4061(a)(1) of the Code.

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26 CFR 48.4061(a)-1: Imposition of tax.

Light-duty truck modified for gooseneck trailer. The modifications made to a customer's light-duty pickup truck by the manufacturer of a gooseneck-type beverage semitrailer designed for use with the truck, thereby increasing the gross combination weight rating from 18,500 to 30,000 pounds but not increasing the gross vehicle weight to over 10,000 pounds, do not affect the exclusion for the truck from tax provided by section 4061(a)(2) of the Code.

Rev. Rul. 76-505

A manufacturer of trailers and semitrailers sells a gooseneck-type beverage semitrailer that is subject to the tax imposed by section 4061(a)(1) of the Internal Revenue Code of 1954. It is designed for use with a pickup truck that has been specifically modified for such use. Pursuant to the trailer company's procedures, a customer purchases elsewhere a pickup truck that has a gross vehicle weight of less than 10,000 pounds and, therefore, it is excluded from the manufacturers excise tax under the provisions of section 4061(a)(2). Further, the truck has a gross combination weight rating (total gross vehicle weight of the vehicle and the weight of the load that it can pull) of 18,500 pounds. The truck is shipped to the company for the modifications that increase the gross combination weight rating to approximately 30,000 pounds.

The modifications consist of replacing the transmission and parking brake with components having greater capacities, and the installation of a fifth wheel attachment or kingpin in the bed of the truck. However, the modifications do not increase the gross vehicle weight of the truck to over 10,000 pounds.

Held, since the modifications do not increase the gross vehicle weight to over 10,000 pounds, the exclusion for the truck from the manufacturers excise tax provided by section 4061(a)(2) of the Code is not affected by such modifications.

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26 CFR 48.4061(a)-1: Imposition of tax.

Hopper, conveyor, and distributor used in ice and snow control on highways. Hopper and conveyor systems designed for use in ice and snow control of highways, mounted on a truck chassis, in the dump box

of a dump truck, in the box of a pickup truck, or on a semitrailer frame to be pulled by a highway tractor are truck or semitrailer bodies subject to the tax imposed by section 4061(a)(1) of the Code unless excluded by section 4061(a)(2); however, no tax attaches to that part of the selling price attributable to the distributor mechanism that spreads the ice and snow control material. Rev. Rul. 165 revoked and Rev. Rul. 72-479 modified.

Rev. Rul. 76-506

Advice has been requested regarding application of the manufacturers excise tax imposed by section 4061(a)(1) of the Internal Revenue Code of 1954 to the articles described below.

Article (1). A "V"-shaped hopper designed to transport sand, salt, cinders, or calcium chloride. The hopper sides slope to a conveyor in the bottom that carries the material to a distributor mechanism, located at the rear, that spreads the material on streets and highways for ice and snow control. This hopper is available in different models that are designed to be either attached to a highway truck chassis, placed in the dump box of a highway dump truck, or placed in the box of a pickup truck. The hoppers are either hydraulically or mechanically operated by means of a power take-off or a separate engine, depending on the model. The hoppers are available in lengths from 8 to 14 feet.

Article (2). A semitrailer designed for use with a highway tractor to transport granular materials on highways. It consists of a two compartment "V"-shaped hopper with an integrated semitrailer frame, retractable landing gear, fifth wheel king pin, air brakes, lights, and a tandem axle assembly located under the rear end of frame. The hopper sides slope to two conveyors in the bottom that carry the material to a distributor mechanism that spreads the material on highways. This unit is hydraulically operated by means of a separate engine. The operation of the engine, the rate of feed, and the width and direction of the spread are controlled from the tractor cab.

Section 4061(a)(1) of the Code imposes a tax upon the sale by the manufacturer, producer, or importer of certain enumerated motor vehicle articles including automobile truck, truck trailer, and semitrailer chassis and bodies.

Section 4061(a)(2) of the Code excludes certain articles from the tax imposed by section 4061(a)(1) including (1) automobile truck chassis and bodies suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less, and (2) truck trailer and semitrailer chassis and bodies suitable for use with a trailer or semitrailer that has a gross vehicle weight of 10,000 pounds or less, and that is suitable for use with a towing vehicle having a gross vehicle weight of 10,000 pounds or less.

Rev. Rul. 165, 1953-2 C.B. 422, holds that hoppers or beds that are primarily designed or adapted to be mounted on or pulled behind trucks or tractors and equipped with power driven devices, used solely in spreading fertilizers or other materials on farms, or in the construction, maintenance of, or spreading ice control materials on highways, streets, sidewalks, etc., are not taxable automobile truck bodies or automobile parts or accessories within the purview of section 3403 of the Internal Revenue Code of 1939 (section 4061 of the 1954 Code).

Rev. Rul. 72-479, 1972-2 C.B. 544, holds that although a standard dump truck body, when equipped with a certain self-feeding spreading device, may temporarily be unsuitable for general use in transporting property over the highway, the designed utility of the body is not affected. Accordingly, the sale of the truck body with the spreading device attached is subject to the tax imposed by section 4061(a) of the Code. Further, Rev. Rul. 72-479 distinguishes such body from the hoppers and beds described in Rev. Rul. 165 in that the latter articles are primarily designed for use in spreading materials over streets and highways. Rev. Rul. 72-479 states that such hoppers and beds, because of their special design, are not suitable for general use in transporting property over the highway.

The hoppers described in *Articles (1)* and *(2)* above are truck or semitrailer bodies even though they are equipped with a mechanism specially designed to spread salt, etc. Although the form of the hoppers and the conveyor systems limit their load carrying capacity and usefulness, they do perform the function of transporting a load over the public highways from a supply point to the point of spreading on the street or highway surface.

Therefore, they are subject to the tax imposed by section 4061(a)(1) of the Code subject to the limitations in section 4061(a)(2). The conveyor mechanism helps unload the body and is accordingly also taxable under section 4061(a)(1) when sold as a part of the body. See Rev. Rul. 74-173, 1974-1 C.B. 310, which holds that if a conveyor discharge system is sold on or in connection with a semitrailer by the semitrailer manufacturer, the tax imposed by section 4061(a)(1) applies to the total price for which the semitrailer and system is sold.

The distributor mechanism, however, applies sand, salt, cinders, calcium chloride, or granular materials and thus performs functions other than in connection with the transportation of property. Therefore, no tax attaches to that part of the selling price of the complete unit that is reasonably attributable to such equipment, provided such part is billed separately on the customer's invoice or can otherwise be adequately substantiated.

The semitrailer chassis described in

Article (2) is designed to transport the hopper over highways in combination with a taxable tractor. Such chassis is therefore subject to the tax imposed by section 4061(a)(1) of the Code unless excluded from the tax under the provisions of section 4061(a)(2).

Pursuant to the authority granted by section 7805(b) of the Code, the conclusion set forth herein with respect to the hopper bodies will not be applied to sales made by manufacturers prior to April 1, 1977.

Rev. Rul. 165 is revoked (however, section 4063(a)(2) of the Code currently provides exemptions for certain types of equipment designed for handling feed, seed or fertilizer on farms). Rev. Rul. 72-479 is modified to remove the distinction made therein between the hoppers and beds described in Rev. Rul. 165 and the standard dump truck body described in Rev. Rul. 72-479.

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26 CFR 48.4061(a)-1: Imposition of tax.

Truck; military use. A one and one-quarter ton, six-by-six motor vehicle which is constructed to military specifications, designed to transport loads by the military in operations where only tracked vehicles formerly were used, and whose use is restricted to tactical and driver training purposes is not a taxable motor vehicle under section 4061(a)(1) of the Code.

Rev. Rul. 76-551

Advice has been requested whether sales by the manufacturer of the article described below are subject to the manufacturers excise tax imposed by section 4061(a)(1) of the Internal Revenue Code of 1954.

A company manufactures and sells a one and one-quarter ton, six-by-six motor vehicle constructed to military specifications. The vehicle is designed for use as a weapons carrier, communications center, frontline ambulance, or prime mover of artillery in forward areas where tracked vehicles are normally used in military operations.

The vehicle has an articulated dual body configuration that permits the motorized tractor and trailing carrier components to roll and pitch independently to provide maximum traction and mobility. It has six wheels and selectable two- or six-wheel drive. Power is transmitted to the rear wheels through the articulated joint, and coordinated four-wheel steering of the front and rear wheels provides reduced turning radius.

The vehicle is constructed of aluminum, has a gross vehicle weight of 10,500 pounds, and may be airlifted and air-dropped with full payload. The watertight body provides floatation for crossing inland waterways even when fully loaded, with wheel propulsion and steering affording a swimming capability. High ground clearance permits the vehicle to negotiate ditches, banks, and other adverse terrain and soil conditions. It can operate on grades up to 60 percent. A maximum speed of 55 miles per hour may be attained on the highway.

A United States Army directive restricts the use of the vehicle to tactical and driver training purposes, and specifically forbids the use of this vehicle for administrative purposes. Because of the special design features of the vehicle, its price is seven to eight times that of the type of vehicle used by the Army for the administrative, over the road, functions behind the forward areas boundries.

Section 4061(a)(1) of the Code imposes a tax upon the sale by the manufacturer, producer, or importer of certain motor vehicles, including automobile truck chassis and bodies.

In the instant case the vehicle is specially designed to transport loads by the military in operations where only tracked vehicles formerly were used. These special design features indicate that the vehicle is not designed for highway use. Accordingly, sales by the manufacturer of the article are not subject to the tax imposed by section 4061(a)(1) of the Code.

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26 CFR 48.4061(a)-1: Imposition of tax.

Truck body and unloader mounted on chasis furnished by customer. A manufacturer of flat-bed truck bodies that fabricates a flat-bed body around a taxable truck unloader, purchased from another manufacturer, and mounts the unit on a customer's truck chassis is a manufacturer of a truck body equipped with a taxable unloader as an integral unit and is subject to tax on the complete unit.

Rev. Rul. 76-552

Advice has been requested as to the applicability of the manufacturers excise tax imposed by section 4061 of the Internal Revenue Code of 1954 to sales of unloading equipment and flat-bed truck bodies under the circumstances described below.

A company is engaged in the business of manufacturing and distributing flat-bed truck bodies and other automotive equipment. In order to provide unloading equipment for use with its truck bodies, the company purchases and offers for sale certain hydraulic-boom truck unloaders. Included with each unloader are such accessories as stabilizing outriggers, and specially constructed longitudinal members. The longitudinals are attached to the base of each unloader serving as a subframe.

Generally the company provides an unloader to a customer in connection with construction of a flat-bed body on a truck chassis owned by the customer. In a typical transaction, the company fabricates the flat-bed body around the unloader in the following manner. The longitudinals attached to the unloader are bolted to the chassis and the body is fabricated on and

around the longitudinals by fastening the body ribs or cross members to them and placing decking on the ribs or cross members and longitudinals. In addition, a steel plate is bolted to the longitudinals and chassis frame to further anchor the body-unloader unit to the chassis.

In some instances, where a truck chassis is not immediately available, the company will fabricate the flat-bed body around the unloader and store the completed unit for later mounting on a truck chasis when brought in by a customer.

In all instances, the body-unloader unit is sold to the customer for a lump-sum price as a single unit.

Section 4061(a)(1) of the Code imposes a tax upon certain enumerated motor vehicles articles (including in each case parts or accessories therefor sold on or in connection therewith or with the sale thereof) sold by the manufacturer, producer, or importer. Among the articles enumerated are automobile truck bodies and chassis.

Section 316.4(a) of Regulations 46, made applicable to the 1954 Code by Treasury Decision 6091, 1954-2 C.B. 47, provides that the term "manufacturer" includes a person who produces a taxable article from scrap, salvage, or junk material, as well as from new or raw material, (1) by processing, manipulating, or changing the form of an article, or (2) by combining or assembling two or more articles.

Rev. Rul. 63-2, 1963-1 C.B. 192, holds that when taxable loading and unloading devices are sold by body manufacturers as integral parts of or on or in connection with taxable bulk transport bodies, the manufacturers excise tax imposed by section 4061(a)(1) of the Code applies to the total price for which the bodies (including the devices) are sold.

In the instant case, the facts establish that when the company assembles an unloader purchased from another manufacturer with a flat-bed truck body and other material of its own fabrication, the company is the manufacturer of a truck body equipped with taxable unloading equipment as an integral part of the body. Accordingly, the company is liable for the tax imposed by section 4061(a)(1) of the Code on its sales of the complete unit consisting of the flat-bed body, unloader, and related accessory equipment. The tax applies to the total selling price charged the customer for the unit as determined under the provisions of section 4216. In accordance with that section, any portion of the selling price attributable to the installation of the unit on a customer-owned chassis may be excluded from the tax base if stated separately on the invoice or if otherwise substantiated by the company's records.

Under section 4221(a)(1) of the Code, the company may purchase directly from the manufacturer or through one intervening purchaser an unloader and related accessories tax free for use in manufacture of the complete unloader unit, provided the parties to the transactions are registered under section 4222. Under the provisions of section 6416(b)(3)(B) if the tax imposed by section 4061(b)(1) was paid by the manufacturer of the unloader on his sale to the company, such tax is deemed to be an overpayment by the company as the subsequent manufacturer and the company is entitled to a credit or refund of the tax paid by the unloader manufacturer.

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26 CFR 48.4061(a)-1: Imposition of tax.

Application of tax where taxable motor vehicle articles transferred to a secured creditor by the trustee of a bankrupt manufacturer are sold by the creditor. See Rev. Rul. 76-492, page 348.

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26 CFR 48.4061(a)-1: Imposition of tax.

Whether the sale of a bus by a manufacturer to a purchaser for use as a school bus for 60 percent of each year is exempt from the manufacturers excise tax imposed by section 4061(a)(1) of the Code. See Rev. Rul. 76-555, page 344.

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26 CFR 48.4061(b)-1: Imposition of tax.

Outside rear-view mirrors. Outside rear-view 4 by 5 inch rectangular convex mirrors and west coast rear-view combination mirrors, consisting of a flat glass mirror and the rectangular convex mirror in separate frames but mounted in the same head having a total viewing area of more than 70 square inches, are taxable parts or accessories; however, junior west coast combination mirrors having a total viewing area of 70 square inches or less are not subject to tax. Rev. Rul. 71-509 amplified.

Rev. Rul. 76-313

Advice has been requested regarding application of the manufacturers excise tax on automotive parts or accessories imposed by section 4061(b)(1) of the Internal Revenue Code of 1954 to sales of the mirrors described below.

A company manufactures and sells an outside rear-view 4 inch by 5 inch rectangular convex mirror, and "west coast" and "junior west coast" rear-view combination mirrors that consist of a flat glass mirror and the rectangular convex mirror in separate frames but mounted in the same head. Both types of west coast combination mirrors are available in box type models with the convex mirror being adjustable, and in flat head type models with the convex mirror being fixed. Each west coast combination has a total viewing area of more than 70 square inches, and each junior west coast combination has a total viewing area of 70 square inches or less.

Section 4061(b)(1) of the Code imposes a tax on parts or accessories (other than tires and inner tubes) for any article enumerated in section 4061(a)(1) sold by the manufacturer, producer, or importer. Enumerated in section 4061(a)(1) are truck and bus

chassis and bodies, truck and bus trailers and semitrailers, and tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.

Section 4061(b)(2) of the Code provides that the tax imposed by section 4061(b) shall not be imposed on any part or accessory that is suitable for use (and ordinarily is used) on or in connection with, or as a component part of, any chassis or body for a passenger automobile, any chassis or body for a trailer or semitrailer suitable for use in connection with a passenger automobile, or a house trailer.

Rev. Rul. 71-509, 1971-2 C.B. 361, established administrative tests for determining the taxability of outside rear-view mirrors. That Revenue Ruling holds that rear-view mirrors, including west coast and junior west coast mirrors, that have a viewing area of 70 squares inches or less will be presumed to be suitable for use and ordinarily used on passenger type vehicles and, therefore, the tax imposed by section 4061(b)(1) of the Code does not apply to sales by manufacturers of such mirrors. On the other hand, rear-view mirrors, including west coast and junior west coast mirrors, that have a viewing area of more than 70 square inches are presumed to be specifically designed for and generally used only with trucks and other section 4061(a)(1) vehicles and are not suitable for use and ordinarily used with passenger type vehicles, Therefore, sales by manufacturers of such mirrors are subject to the tax imposed by section 4061(b)(1). Rev. Rul. 71-509 further holds that round convex mirrors that have diameters of more than 3¾ inches are considered to be designed for use with trucks and other section 4061(a)(1) articles and not suitable for use and ordinarily used with passenger type vehicles. Therefore, sales by manufacturers of such mirrors are subject to the tax imposed by section 4061(b)(1).

Although the west coast and junior west coast mirrors contemplated by Rev. Rul. 71-509 are the basic conventional types that have only flat glass mirrors, the administrative test established therein for such mirrors is equally applicable to the west coast combination mirrors described above. With respect to separate convex mirrors, those discussed in Rev. Rul. 71-509 differ functionally from flat glass mirrors and are treated apart from the others in that Revenue Ruling.

Since the convex mirror in the instant case has a larger viewing area than a round convex mirror having a diameter of 3¾ inches, pursuant to the test set forth in Rev. Rul. 71-509, it is designed for use on trucks and other vehicles enumerated in section 4061(a)(1) of the Code. The fact that it is rectangular rather than round is not material. Therefore, separate sales by the manufacturer of such convex mirror are subject to the tax imposed by section 4061(b)(1).

Accordingly, in the instant case, the west coast combination mirrors that have a total viewing area of more than 70 square inches are presumed to be specifically designed for and generally used only with trucks and other section 4061(a)(1) vehicles, and are not suitable for use and ordinarily used with vehicles specified in section 4061(b)(2). Therefore, sales by the manufacturer of such mirrors are subject to the tax imposed by section 4061(b)(1) of the Code unless the manufacturer establishes to the satisfaction of the Internal Revenue Service that a particular combination mirror is suitable for use and is ordinarily used with section 4061(b)(2) vehicles, despite the fact that the total viewing area is in excess of 70 square inches.

On the other hand, the junior west coast combination mirrors that have a total viewing area of 70 square inches or less are presumed to be suitable for use and ordinarily used with section 4061(b)(2) vehicles. Therefore, sales by the manufacturer of such mirrors are not subject to the tax imposed by section 4061(b)(1) of the Code.

Rev. Rul. 71-509 is amplified.

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26 CFR 48.4061(b)-2: Definition of parts or accessories.

Truck flooring planks. Laminated wood flooring planks sold with standard lumber dressing for use in automobile truck, truck trailer, and semitrailer bodies and for nonautomotive uses are materials of a general use and are not taxable parts or accessories. However, planks sold after being cut and milled to specifications that are to the exact or approximate dimensions of one or more automobile truck bodies are floors in knockdown condition and are taxable; Rev. Rul. 64-261 superseded.

Rev. Rul. 76-478

Advice has been requested as to the application of the manufacturers excise tax on automotive parts or accessories imposed by section 4061(b)(1) of the Internal Revenue Code of 1954 to sales of wood flooring in the situations set forth below.

A company manufactures laminated wood flooring planks. The planks are sold to purchasers with square, tongue and groove, or shiplap edges. The company sells the flooring planks for manufacture of automobile truck, truck trailer, and semitrailer bodies; for automotive repair or replacement purposes; and, in some instances, for nonautomotive uses. Described below are two situations with respect to which advice has been requested.

Situation (1). The company sells flooring planks of equal or varying thickness, width, length, and quantity, and which are dressed by the company to standard lumber dressing as follows:

S2S-SL	Surfaced two sides with shiplap
S3S-BL	Surfaced three sides with bottom lap

S3S-TL	Surfaced three sides with top lap
S2S-T&G	Surfaced two sides with tongue and groove
S3S-T	Surfaced three sides with tongue
S3S-G	Surfaced three sides with groove
S4S	Surfaced four sides
S4S-EE	Surfaced four sides with eased edges

The purchaser cuts and otherwise alters the planks as needed for use in automobile truck, truck trailer, and semitrailer bodies.

Situation (2). The company sells a set of standard dressed flooring planks to a purchaser cut to certain thicknesses, widths and lengths. The purchaser's order specifies that the planks are to be further cut, milled, etc. For example, in this instance, the purchase order requests that some of the planks have corners beveled, that there be cut-outs for corner posts or side doors, and that notches be made on the top or bottom of the ends or edges of some of the planks. Although the purchase order does not expressly so state, the further cutting, milling, etc. is to the extact or approximate dimensions and design of one or more automobile truck bodies. In addition, cutting or other minor alterations may be necessary before actual installation of the planks as a truck floor is accomplished.

Section 4061(b)(1) of the Code imposes a tax upon parts or accessories (other than tires and inner tubes) for any article enumerated in section 4061(a)(1) sold by the manufacturer, producer, or importer. Enumerated in section 4061(a)(1) are automobile truck and truck trailer and semitrailer bodies.

Section 48.4061(b)-2(a) of the Manufacturers and Retailers Excise Tax Regulations provides that, in general, the term "parts or accessories" includes (1) any article the primary use of which is to improve, repair, replace, or serve as a component part of an automobile truck or bus chassis or body, or taxable tractor, (2) any article designed to be attached to or used in connection with such chassis, body, or tractor, to add to its utility or ornamentation, and (3) any article the primary use of which is in connection with such chassis, body, or tractor, whether or not essential to its operation or use. The term parts or accessories includes all articles that have reached such a stage of manufacture as to be commonly known as parts or accessories whether or not fitting operations are required in connection with their installation.

Section 48.4061(b)-2(c) of the regulations provides that the term parts or accessories does not include material such as glass and other material sold in rolls or by the foot. However, except as the regulations provide for articles made for immediate installation or repair, when any such material is cut or otherwise transformed by any person into an automobile part or accessory, tax attaches at the time such part or accessory is sold by such person.

Under the provisions of section 316.4(c) of Regulations 46, made applicable to the 1954 Code by Treasury Decision 6091, 1954-2 C.B. 47, a manufacturer who sells a taxable article in a knockdown condition, but complete as to all component parts, is liable for the tax.

Rev. Rul. 64-261, 1964-2 C.B. 415, holds that laminated flooring planks that require cutting, etc., before they may be used as flooring planks in automobile truck or trailer bodies are "materials of a general use" within the meaning of the regulations. However, a group of such planks that are cut to the dimensions of a taxable truck or trailer body to provide a floor for such body, comprise an automotive part or accessory.

In the case of *Burruss Land & Lumber Co., Inc.* v. *United States,* 456 F. 2d 38 (4th Cir. 1972), reversing *Burruss Land and Lumber Co., Inc.* v. *United States,* 318 F. Supp. 360 (W.D. Va. 1970), the court concluded that certain laminated wood flooring was a part or accessory within the purview of section 4061(b) of the Code. The court noted that the taxpayer's laminated flooring was designed, advertised, and most often used, as a truck floor. In addition, the laminated wood was cut by the manufacturer pursuant to an individual order to the exact specifications submitted by the customer, including the length and width of a particular truck floor or floors. Consequently, only a few minor alterations, such as notching the ends of some boards and drilling holes, were necessary prior to the installation of the floors.

In producing the flooring planks for sale in the manner set forth in *Situation 1,* the company has not manufactured articles that have reached such a stage of manufacture as to be commonly known as parts or accessories. Rather, the flooring planks that are sold by the company are "materials of a general use" as contemplated by section 48.4061(b)-2(c) of the regulations.

On the other hand, in producing the floor planks for sale in the manner set forth in *Situation 2,* the company has cut, milled, and otherwise transformed the flooring planks so as to have manufactured "floors" for taxable vehicle bodies. Moreover, such floors have reached such a stage of manufacture as to be parts or accessories within the meaning of section 48.4061(b)-2(a) of the regulations. Therefore, under the example in *Situation 2,* the company is selling a floor for an automobile truck in a knockdown condition.

Accordingly, the company incurs no liability for the manufacturers excise tax on automotive parts or accessories with respect to its sales of the flooring in the manner described in *Situation 1.*

However, the company does incur liability for the manufacturers excise tax on automotive parts or accessories

with respect to its sales of the truck floors described in *Situation 2*, unless such sales are made tax free under the provisions of section 4221 of the Code. For example, sales of floors to a purchaser for further manufacture of a truck body may be made tax free, subject to the registration requirements of section 4222. However, sales of floors for replacement purposes cannot be made tax free.

When the entire floor of a taxable truck, truck trailer, or semitrailer body is installed or replaced (other than with floors purchased under the circumstances of *Situation 2*), the owner of the body has manufactured from materials of general use an automotive part, viz., a floor for a truck, trailer, or semitrailer body. Accordingly, the owner of such body will become liable for manufacturers excise tax on *use* of the floor by such owner under the provisions of section 4218(c) of the Code.

Compare Rev. Rul. 75-417, 1975-2, C.B. 425, which relates to the taxability of steel floor coverings for wooden truck floors.

Rev. Rul. 64-261 is clarified, and, as clarified, is superseded since this position is restated in this Revenue Ruling.

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26 CFR 48.4061(b)-2: Definition of parts or accessories.

Multi-purpose winches. Winches with no unique characteristics of construction or design that identify them as for use primarily in connection with taxable automotive vehicles, sold without accessories to adapt them for such use, are not parts or accessories within the meaning of section 4061(b)(1) of the Code. However, upon modification for use on taxable motor vehicles, winches of this type will become parts or accessories.

Rev. Rul. 76-507

Advice has been requested whether the winches described below are subject to the manufacturers excise tax on automotive "parts or accessories" imposed by section 4061(b)(1) of the Internal Revenue Code of 1954.

A company manufactures and sells a variety of multi-purpose winches. The winches are designed to meet the fullest possible variation of uses with respect to mechanical pulling and holding ability. The company sells the winches primarily to independent distributors who in turn sell the winches to equipment manufacturers or directly to companies in the logging, mining, farming, construction, petroleum and utility industries for a variety of nonautomotive applications. However, they are also sold to truck dealers and truck chassis manufacturers for use as original equipment, or as replacement parts, on taxable automotive vehicles. Nevertheless, the company basically sells what is called a "bare" winch, that is, a winch without mounting brackets, power hookups, accessories or any specific adaptations that otherwise would be indicative of a specific end-use application. Further, the base of the bare winch when sold by the company is not bored or drilled.

Section 4061(b)(1) of the Code imposes a tax on parts or accessories (other than tires and inner tubes) for any of the articles enumerated in section 4061(a)(1) when sold by the manufacturer, producer, or importer. Among the articles enumerated in section 4061(a)(1) are chassis and bodies for trucks and truck tractors.

Section 48-4061(b)-2(a) of the Manufacturers and Retailers Excise Tax Regulations provides that, in general, the term parts or accessories includes (1) any article the primary use of which is to improve, repair, replace, or serve as a component part of an automobile truck or bus chassis or body, or taxable tractor, (2) any article designed to be attached to or used in connection with such chassis, body, or tractor, to add to its utility or ornamentation, and (3) any article the primary use of which is in connection with such chassis, body, or tractor, whether or not esssential to its operation or use.

Section 48.4061(b)-2(b) of the regulations provides that the term parts or accessories does not include articles which are not used primarily in the manufacture, repair, etc. of automobile trucks or tractors, but have a general use in the manufacture, repair, etc. of various articles.

Section 4218(c) of the Code provides that if any person manufactures, produces, or imports a part or accessory taxable under section 4061(b) and uses it (otherwise than as material in the manufacture, or production of, or as a component part of, any other article to be manufactured or produced by such person) that person shall be liable for the tax in the same manner as if such article were sold by the manufacturer, producer, or importer.

Although in the instant case the bare winches may be used on taxable motor vehicles, they possess no unique characteristics of construction or design (such as base bored or drilled), when sold by the winch manufacturer to identify them as being designed or intended for use primarily in connection with taxable automotive vehicles. Further, there is no substantial evidence in the marketing practices of the industry to conclude that winches of the type here considered are primarily used in connection with articles taxable under section 4061(a)(1) or that the sales of winches of this type are primarily directed to taxable automotive applications. Therefore, they are not automotive parts or accessories but are articles of general use within the meaning of section 48.4061(b)-2(b) of the regulations.

Accordingly, sales of the bare winches by the manufacturer are not subject to the manufacturers excise tax imposed by section 4061(b)(1) of the Code. Compare Rev. Rul. 69-322, 1969-1 C.B. 281, where winches

that are primarily designed for use on or in connection with taxable vehicles, are taxable parts or accessories.

However, when a general purpose bare winch is modified so that it is primarily designed for use on or in connection with a chassis or body enumerated in section 4061(a)(1) of the Code, it becomes a "part or accessory" within the meaning of section 4061(b)(1). When the person who is the manufacturer because of such modification sells or uses the winch, such person is liable for the tax imposed by either that section on the sale or by section 4218(c) on the use.

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26 CFR 48.4061(b)-2: Definition of parts or accessories.

Safety props for end-dumping truck and trailer bodies. Safety props designed primarily for use in connection with taxable truck and trailer end-dumping bodies to support the body in a raised position and prevent it from accidentally falling are taxable parts or accessories under section 4061(b)(1) of the Code.

Rev. Rul. 76-553

Advice has been requested whether the article described below is an automotive part or accessory subject to the manufacturers excise tax imposed by section 4061(b)(1) of the Internal Revenue Code of 1954.

A company manufactures an article known as a safety prop. It is designed to support truck and trailer end-dumping bodies in a raised position. The prop is sold with dump bodies or separately. The prop consists of a metal tube with a bracket, pin, and clamp or shackle. The prop is installed on a stringer attached to the underside of the dump body. One end of the prop is permanently attached to the stringer by the bracket and pin. When the prop is not in use, it is folded along the stringer and held in place by the clamp or shackle on the stringer. Raising the dump body at its forward end allows the prop, when unlocked, to pivot on the pin until its free end swings down and fits into a recess in the frame of the vehicle's chassis. In that position the prop supports the elevated end of the dump body and prevents the body from accidentally falling. The props of this type are primarily used with a taxable dump body.

Section 4061(a)(1) of the Code imposes a tax on the sale of the manufacturer, producer, or importer of certain enumerated motor vehicle articles (including in each case parts or accessories therefor sold on or in connection therewith or with the sale thereof). Among the articles enumerated in that section are chassis and bodies for trucks, trailers, and semitrailers.

Section 4061(b)(1) of the Code imposes a tax upon parts or accessories (other than tires and tubes) for any of the articles enumerated in section 4061(a)(1) when sold by the manufacturer, producer, or importer. Among the articles enumerated in section 4061(a)(1) are chassis and bodies for trucks, trailers, and semitrailers.

Section 48.4061(b)-2(a) of the Manufacturers and Retailers Excise Tax Regulations provides that, in general, the term "parts or accessories" includes (1) any article the primary use of which is to improve, repair, replace, or serve as a component part of an automobile truck or bus chassis or body, or taxable tractor, (2) any article designed to be attached to or used in connection with such chassis, body, or tractor to add to its utility or ornamentation, and (3) any article the primary use of which is in connection with such chassis, body, or tractor, whether or not essential to its operation or use.

The safety prop described above is an article designed to be attached to, and primarily used in connection with, taxable end-dumping truck and trailer bodies to add to their utility. Therefore, the prop is an automotive part or accessory within the meaning of section 4061(b)(1) of the Code and the manufacturer is liable for the tax imposed by that section on its separate sales of such prop. Further, where the prop is sold by the body manufacturer in connection with the sale of its taxable truck or trailer bodies the prop is subject to the tax imposed by section 4061(a)(1).

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26 CFR 142.1-1: Imposition of tax; exclusion for light-duty trucks, etc.; exemptions for local transit buses and trash containers.

Manufacturers; light duty semitrailer; overhang reducing axle capacity. The reduced axle capacity of a semitrailer resulting from an increase in the axle overhang, substantiated by engineering data of the axle manufacturer, will be used to determine the total of the axle ratings for purposes of the exclusion provided in section 4061(a)(2) of the Code.

Rev. Rul. 76-433

Advice has been requested whether, under the circumstances described below, axle overhang is a factor in determining "axle capacity" for purposes of establishing gross vehicle weight ratings under section 4061(a)(2) of the Internal Revenue Code of 1954.

A company manufactures and sells tandem axle semitrailers. In the manufacture of a semitrailer the placement of each axle is determined by the location and placement of the springs under the chassis of the semitrailer. The springs are secured to the chassis by spring hangers or brackets welded to specific points on the underside of the chassis. The design of the chassis determines the location of the points on the frame where the spring hangers are located. When the axles are attached to the springs, the resulting distance along the axles from the centerline of the springs to the centerline of the tires is referred to as "overhang."

The greater the overhang the less the carrying capacity of the axle beam.

The axles purchased by the company for use in the manufacture of semitrailers are rated by the axle manufacturer at the highest potential capacity of the axle with minimum overhang. However, because of the design of the company's semitrailers, axle overhang is increased. As a result the semitrailers cannot use the highest potential carrying capacity of the axles as rated by the axle manufacturer.

Section 4061(a)(1) of the Code imposes a tax on the sale by the manufacturer, producer, or importer of certain enumerated articles including trailer and semitrailer chassis and bodies.

Section 4061(a)(2) of the Code excludes from the tax imposed by section 4061(a)(1) truck trailer and semitrailer chassis and bodies suitable for use with a trailer or semitrailer having a gross vehicle weight of 10,000 pounds or less (as determined under regulations prescribed by the Secretary or the Secretary's delegate) provided such trailer or semitrailer is suitable for use with certain towing vehicles that also have a gross vehicle weight of 10,000 pounds or less.

Section 142.1-1(d)(3) of the Temporary Excise Tax Regulations under the Revenue Act of 1971, provides, in pertinent part, that gross vehicle weight means the maximum total weight of a loaded vehicle. The maximum total weight shall be the gross weight rating of the article (as manufactured) as specified or established by the manufacturer of the completed article unless such rating is unreasonable in light of the facts or circumstances in a particular case. The manufacturer's gross vehicle weight rating with respect to articles sold after January 31, 1972, must take into account the strength of the chassis frame, the axle capacity and placement, and the spring, brake, rim and tire capacities. The unit with the lowest rating ordinarily shall be considered determinative of the gross vehicle weight. If the capacity of any of the readily attachable components (springs, brakes, tires, or rims) would be otherwise determinative of a gross vehicle weight rating of 10,000 pounds or less, no readily attachable component will be taken into account in determining such rating unless the rating determined solely on the basis of the chassis frame or the total of the axle ratings is 12,000 pounds or less. For this purpose, the term "total of the axle ratings" means the sum of the maximum load carrying capability of the axles (without regard to rims, tires, springs and brakes).

Since axle overhang does not involve the capacity of readily attachable components but rather the placement of certain components as a part of chassis design, it is a limiting factor in arriving at the total of the axle ratings.

Therefore, under the circumstances described above, where a reduced axle capacity rating due to increased overhang is substantiated from engineering data available from the axle manufacturer, such reduced axle capacity is to be used for the purpose of determining the total of the axle ratings under section 142.1-1(d)(3) of the regulations.

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26 CFR 142.1-1: Imposition of tax; exclusion for light-duty trucks, etc.; exemptions for local transit buses and trash containers.

Light-duty truck; fifth wheel attachment. A light-duty pickup truck equipped with a fifth wheel attachment is a truck for purposes of the exclusion from the manufacturers tax provided by section 4061(a)(2) of the Code.

Rev. Rul. 76-554

Advice has been requested whether a certian light-duty truck equipped with a fifth wheel attachment is a truck so that the exclusion from tax provided by section 4061(a)(2) of the Internal Revenue Code of 1954 applies, or a truck-tractor so that the exclusion does not apply.

A company manufactures and sells light-duty pickup trucks that have a gross vehicle weight of 10,000 pounds or less. A truck or trailer dealer then installs a removable bar and fifth wheel attachment in the truck bed so that the truck may tow a gooseneck semitrailer. The fifth wheel attachment is placed across the bed over the rear axle and fitted into brackets mounted on either side of the bed.

Section 4061(a)(1) of the Code imposes a tax upon the sale by the manufacturer, producer, or importer of certain enumerated motor vehicle articles, including automobile truck chassis and bodies and tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.

Section 4061(a)(2) of the Code excludes from the tax imposed by section 4061(a)(1), sales by the manufacturer, producer, or importer of automobile truck chassis and bodies suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less (as determined under regulations prescribed by the Secretary or the Secretary's delegate).

Rev. Rul. 76-559, page 365, this Bulletin, holds that a pickup truck equipped with a fifth wheel attachment is primarily designed for the transportation of property and since, when so equipped, the vehicle customarily tows certain semitrailers, it is within the truck-trailer category of the use tax schedule prescribed for determinations of the highway use tax imposed by section 4481 of the Code. That Revenue Ruling states that a pickup truck, so equipped, retains its primary character as a truck.

Accordingly, the pickup truck with the fifth wheel attachment in the instant case is a truck for purposes of section 4061(a)(2) of the Code rather than a truck-tractor.

Section 4063.—Exemptions

Whether a certain body designed to be

mounted on a truck chassis for use in hauling and stacking baled hay and for use as an all-purpose dump body, and certain optional accessories, are exempt from the tax imposed by section 4061 of the Code. See Rev. Rul. 76-254, page 332.

Whether a certain dump semitrailer body manufactured and sold for use in hauling grain, seed, fertilizer, and livestock is exempt from the tax imposed by section 4061 of the Code. See Rev. Rul. 76-361, page 276.

Whether the exemption from manufacturers excise tax relating to house trailers applies to certain gooseneck horse/travel semitrailers. See Rev. Rul. 76-432, page 334.

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26 CFR 142.1-1: Imposition of tax; exclusion for light-duty trucks, etc.; exemptions for local transit buses and trash containers. (Also Section 4061.)

Buses; mass transportation service; intercity route. An intercity bus service, connecting two cities with populations between 100,000 and 500,000 and located 51 miles apart, serving both the cities and their suburbs with the majority of passenger traffic being carried within either city or between either city and its immediate suburban area, with only a small percentage of passengers traveling from one city to the other, qualifies as mass transportation service within urban areas for purposes of the exemption from the manufacturers excise taxes.

Rev. Rul. 76-285

Advice has been requested whether the bus service described below is mass transportation service in an urban area, for purposes of the manufacturers excise tax exemption provided by section 4063(a)(6) of the Internal Revenue Code of 1954.

A bus manufacturer sold some intercity type buses for use in providing public transportation on a certain bus route. The route, fares, and schedule are subject to regulation by State authorities. The purchaser intends to use the buses along the route for more than 50 percent for each year of their estimated useful lives based on both hours of use and mileage.

The buses are used to transport passengers along a route between *city X* and *city Y*, and four buses travel daily in each direction. The populations of cities *X* and *Y* are both in excess of 100,000 (but less than 500,000). The route between cities *X* and *Y* is 51 miles long, and passes through nine towns. The areas close by the cities are suburban, but the population density thins out to primarily rural areas midway between the cities. Subject to minor restrictions, the bus company is authorized to pick up and discharge passengers anywhere along the route. Discount commuter tickets are available, but the revenue derived from the operation does not meet the 60 percent passenger fare revenue test provided by section 6421(b)(2) of the Code.

A turnpike runs between *city X* and *city Y* that is used by other buses to transport persons nonstop directly between the two cities. The subject buses do not use the turnpike. They use roads along which there are, in addition to residential areas, numerous schools, commercial establishments and other businesses.

The results of a ridership survey submitted indicates that of all the passengers boarding in *city X* only 5 percent travel the full distance to *city Y*. On the trip from *city Y* to *city X* the survey indicates that a similar percentage of those boarding in *city Y* travelled all the way to *city X*. On the runs from *city X* to *city Y*, 75 percent of all passengers carried boarded in *city X*, and 60 percent of those who boarded in *city X* disembarked either in *city X* or in suburbs thereof within 10 miles of the city. On the runs from *city Y* to *city X* there is a similar concentration of passenger travel within the two cities and between the cities and their surrounding suburbs.

Section 4061(a)(1) of the Code imposes a tax upon certain enumerated motor vehicle articles (including in each case parts or accessories therefore sold on or in connection therewith or with the sale thereof) when sold by the manufacturer, producer, or importer. Among such articles are automobile bus chassis and bodies.

Section 4063(a)(6) of the Code provides that the tax imposed under section 4061(a) shall not apply in the case of automobile bus chassis or bodies that are to be used predominantly by the purchaser in mass transportation service in urban areas.

Section 142.1-1(e) of the Temporary Excise Tax Regulations under the Revenue Act of 1971 provides that, for purposes of the exemption from manufacturers excise tax provided by section 4063(a)(6) of the Code, a bus will be considered to be purchased for predominant use in mass transportation in an urban area if the ultimate purchaser of the article intends to use the article in such service for more than 50 percent for each year of its estimated useful life based on both hours of use and mileage. Furthermore, the exemption applies to buses that are to be operated in a local, scheduled, common carrier public passenger service or chartered transportation service for commuters, on a continuing basis, along regular routes in cities and towns and the suburbs thereof. The exemption provided by section 4063(a)(6) does not apply to buses that are to be operated predominantly on intercity routes.

Section 3.02 of Rev. Proc. 74-1, 1974-1 C.B. 411, states in part that for purposes of the exemption provided by section 4063(a)(6) of the Code, an urban area is defined as including an "urban center" and its "surrounding area." Urban center is defined in the Revenue Procedure as any city or town with a population in excess of 100,000 inhabitants, and surrounding area is defined in part as the area surrounding the urban center that is within 20 miles of the center's boundary if the urban center's popu-

lation is in excess of 100,000 but not greater than 500,000.

Section 4.02 of Rev. Proc. 74-1 provides that even though a bus does not qualify under the specific guidelines set forth in section 3 of that Revenue Procedure as a bus sold for predominant use in mass transportation service in urban areas, it may nevertheless qualify on the basis of consideration of other factors. Section 4.02 further provides that upon request the National Office of the Internal Revenue Service will make a determination with respect to a bus service that does not qualify for the exemption under the guidelines provided in section 3 of Rev. Proc. 74-1, if certain described information is submitted for consideration.

The service provided between the two cities does not qualify as service within an urban area within the guidelines set forth in section 3.02 of Rev. Proc. 74-1. However, as indicated in section 4.02 of that Rev. Proc., a bus service may otherwise qualify as mass transportation service in an urban area on the basis of other factors referred to in the Revenue Procedure.

The results of the ridership survey submitted indicate that the great majority of passengers carried on the route in question travel relatively short distances, either within the cities or between the cities and their suburbs. The intercity passenger traffic is only incidental to the primary use of the buses, which is transportation of passengers either within the cities or between the cities and their respective suburbs.

As provided in section 142.1-1(e) of the regulations, the exemption is available for buses to be used predominantly by the purchaser in mass transportation service in an urban area, but the exemption does not apply to buses that are to be operated predominantly on intercity routes. Thus, a bus route between two cities is usually not mass transportation in urban areas. However, it is not the intention of the law or regulations to deny exemption solely because service is provided between two nonadjacent cities if the service provided in each city when considered separately is primarily mass transportation service within an urban area, within the meaning of section 4063(a)(6) of the Code, and the intercity transportation of passengers is a minor incident of the overall traffic pattern. Rather, the phrase "intercity routes" as used in the foregoing regulations means bus routes that are predominantly used for intercity transportation.

On the basis of the facts presented, the bus service provided to *city X* and *city Y*, considered separately, is mass transportation in an urban area. Accordingly, the total described bus service between cities *X* and *Y* is mass transportation service within urban areas for purposes of the exemption from manufacturers excise tax provided by section 4063(a)(6) of the Code.

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26 CFR 142.1-1: Imposition of tax; exclusion for light-duty trucks, etc; exemptions for local transit buses and trash containers. (Also Sections 4061, 4221; 48.4061(a)-1, 145.3-1.)

Exemption; partial use of bus as school bus in urban area. The sales of a bus by the manufacturer to a purchaser who intends to use the bus 60 percent of each year to transport students and employees of schools operated by State or local governments or by nonprofit educational organizations and 40 percent for private charter service is not exempt from the manufacturers tax either as a bus used exclusively as a school bus under section 4221(e)(5) of the Code or as a bus used predominantly in mass transportation under section 4063(a)(6).

Rev. Rul. 76-555

Advice has been requested whether the sale of a bus by a manufacturer under the circumstances described below is exempt from the manufacturers excise tax either under section 4221(e)(5) of the Internal Revenue Code of 1954 or under section 4063(a)(6).

A manufacturer sells a bus to a purchaser who intends to use the bus 60 percent of each year (based on both hours of use and mileage) to transport students and employees of schools operated by State or local governments or by nonprofit educational organizations. The bus is to operate within an urban area at scheduled times and along regular routes. During the remaining 40 percent of the year, the bus is to be used in private charter service, that is, for charters to parties other than State and local governments or nonprofit organizations.

Section 4061(a)(1) of the Code imposes a tax upon certain enumerated articles (including in each case parts or accessories therefor sold on or in connection therewith or with the sale thereof) sold by the manufacturer, producer, or importer. Among such articles are automobile bus chassis and bodies.

Section 4063(a)(6) of the Code provides that the tax imposed by section 4061(a)(1) shall not apply in the case of automobile bus chasiss or automobile bus bodies which are to be used predominantly by the purchaser in mass transportation service in urban areas.

Section 4221(e)(5) of the Code provides that the tax imposed by section 4061(a)(1) shall not apply to a bus sold to any person for use exclusively in transporting students and employees of schools operated by State or local governments or by nonprofit educational organizations. That section further provides that incidental use of a bus in providing transportation for a State or local government or a nonprofit organization described in section 501(c) which is exempt from tax under section 501(a) shall be disregarded.

Section 142.1-1(e) of the Temporary Excise Tax Regulations under

the Revenue Act of 1971, Pub. L. 92-178, 1972-1 C.B. 443, provides that, for purposes of section 4063(a)(6) of the Code, a bus will be considered to be purchased for predominant use in mass transportation service in an urban area if the ultimate purchaser of the article intends to use the article in such service for more than 50 percent for each year of its estimated useful life based on both hours of use and mileage. This paragraph applies to buses which are to be operated in local, scheduled, common carrier public passenger service or chartered transportation service for commuters, on a continuing basis, along regular routes in cities and towns and the suburbs thereof. The exemption does not apply to buses which are to be operated predominantly on intercity routes.

Since the purchaser in the instant case does not intend to use the bus exclusively in transporting students and employees of schools operated by State or local governments or by nonprofit educational organizations, the exemption provided by section 4221(e)(5) of the Code does not apply to the sale of the bus by the manufacturer to the purchaser. The use of the bus in private charter services could not be "incidental use" within the meaning of that section, since that section allows for incidental use only in providing transportation for a State or local government or nonprofit organization.

The exemption provided by section 4063(a)(6) of the Code for the sale of buses to be used predominantly in mass transportation service in urban areas cannot be interpreted to apply to the sale of a bus to be used predominantly for school bus transportation for students and school employees in an urban area. In enacting section 4221(e)(5), which deals specifically with school buses, Congress explicitly provided that the sale of a bus for use *exclusively* in transporting students and employees of public schools and schools operated by nonprofit educational organizations would be exempt from the manufacturers excise tax. If mass transportation service were interpreted to include school transportation, section 4063(a)(6) would exempt the sale of a bus to be used only *predominantly* for school use in an urban area and would conflict with the purpose of section 4221(e)(5).

In enacting section 4063(a)(6) of the Code, Congress did not amend section 4221(e)(5). Rather, it intended to encourage private participation in mass transit in urban areas by eliminating the manufacturers excise tax burden of private bus companies. See 117 Cong. Rec. 41097-98 (1971) (remarks of Senator Williams as sponsor of the exemption under section 4063(a)(6) and Senator Randolph). The requirement of the more specific statutory exemption, that is, the exclusive use requirement of the school bus exemption of section 4221(e)(5), should govern.

Accordingly, the exemption provided by section 4063(a)(6) of the Code does not apply to the sale of the bus by the manufacturer to the purchaser in the instant case.

However, where a bus is sold for use by a transit company or other purchaser in providing transportation more than 50 percent of which is mass transportation service in an urban area within the meaning of section 4063(a)(6) of the Code, the exemption will apply to the sale of such bus even though the purchaser may also use such bus to the extent of less than 50 percent in providing transportation for students and employees of schools operated by State or local governments or by nonprofit education organizations. In such case, whether the lesser use of the bus is in school transportation is immaterial since the bus would qualify for the exemption on the basis of its predominant use in mass transportation in an urban area.

Part II.—Tires and Tubes

Section 4071.—Imposition of Tax

26 CFR 48.4071-1: Imposition and rates of tax.
(Also Section 7805; 301.7805-1.)

Tires; adjustment under warranty. A method is set forth for computing the credit or refund of tax allowable to a manufacturer that makes price adjustments under its warranty on replacement tires sold to dealers to replace defective tires bearing its brand label, or sold under the dealer's brand label and replaced with tires of another manufacturer, with the dealer's account being credited for the adjustment. No credit or refund is allowable, however, with respect to tires sold to dealers at a price reduction in lieu of warranty.

Rev. Rul. 76-423

Advice has been requested as to the manufacturers excise tax consequences where adjustments are made on defective tires in the situations described below.

Situation 1. *M* manufactures and sells tires under warranty to tire dealer *N*. The tires carry the brand label of *M*. *N* sells the tires to the consumer under *M's* warranty that provides for a price adjustment if the tire proves defective.

Whenever a defect in a tire occurs, pursuant to a warranty agreement, another tire is sold to the consumer by *N* at an adjusted sales price. Pursuant to *M's* warranty, if the adjusted sales price by *N* is less than the regular sales price from *M* to *N*, *M* either (1) grants *N* a credit on its account equal to the regular sales price for a tire from *M* to *N* less the amount of the adjusted sales price to the consumer of the replacement tire, or (2) sells another tire to *N* for the amount *N* received for the replacement tire sold to the consumer.

Situation 2. *X* and *Y* manufacture and sell tires to tire dealer *Z*. The

tires carry *Z's* private brand label. *Z* sells the tires to the consumer under a warranty that provides for a price adjustment if the tire proves defective. *X* and *Y* give to *Z* the same type of warranty on the tires they sell to *Z* that *Z* gives to the consumer.

When a defect in a tire occurs, *Z* sells the consumer a replacement tire under its warranty to the consumer at an adjusted price. However, the replacement tire and the defective tire may not necessarily be made by the same manufacturer. Through identification codes and symbols, *Z* can determine whether the defective tire was manufactured by *X* or *Y*.

Pursuant to their warranties with *Z*, depending on who was the manufacturer, *X* or *Y* makes an adjustment with *Z*. The adjustment by *X* or *Y* is the same percentage of its sale price to *Z* as *Z's* percentage adjustment in its sale price to the consumer. *X* or *Y* either (1) grants *Z* a credit on its account based upon the percentage adjustment computation or (2) sells a replacement tire to *Z* based on the percentage adjustment computation.

Situation 3. The facts are the same as those in *Situations 1* or *2* except that instead of the manufacturer giving its usual warranty to the dealer it sells tires to the dealer under a price reduction arrangement in lieu of a warranty (a standard price without warranty). However, the dealer also pays an amount, in addition to the price, to the manufacturer who places it in the tire adjustment reserve for the dealer for a specified period of time. Charges are made to the reserve when the manufacturer makes adjustments for defective tires sold to the dealer. At the end of the specified period if the charges exceed the reserve the dealer reimburses the manufacturer for the excess, or if the charges are less than the reserve the balance is refunded to the dealer. This arrangement effectively removes the future liability of the manufacturers of the tires that prove defective.

Section 4071(a) of the Internal Revenue Code of 1954 imposes a tax on the sale by the manufacturer, producer, or importer of tires made wholly or in part of rubber.

Rev. Rul. 59-394, 1959-2 C.B. 280 holds that when a tire manufacturer sells a customer a new replacement tire at a reduced price pursuant to a guaranty contract, the manufacturers excise tax on the replacement tire is computed upon that proportion of the total weight of the second tire that the actual sale price bears to the regular sale price of the second tire.

Under the rationale of Rev. Rul. 59-394, a tire manufacturer would be allowed a proportionate credit or refund of the excise tax imposed by section 4071(a) of the Code when it makes an actual, after-the-fact price adjustment pursuant to a warranty on a tire that proves defective. The credit or refund shall be computed in proportion to the extent of the manufacturer's warranty, and his obligations thereunder.

With respect to *Situation 1*, either of the two methods used by *M* satisfies the requirements of Rev. Rul. 59-394 for an adjustment in price of the replacement tire. Under Rev. Rul. 59-394 the excise tax on the replacement tire is computed in the following manner:

$$\text{Total weight of the replacement tire} \times \frac{\text{adjusted price allowed to } N \text{ under } M\text{'s warranty}}{\text{regular sales price of the tire from } M \text{ to } N} \times \text{the tax rate}$$

Accordingly, in *Situation 1*, method (1), since *M* has paid the full excise tax on the replacement tire, the difference between the tax paid by *M* and the adjusted tax computed in the manner set forth above will be allowed to *M* as a credit against tax or as a refund. In method (2), the tax on the replacement tire sold by *M* to *N* at a reduced price is also computed in the manner set forth above.

For example, a tire is sold by *M* to *N* for $13.00 and *N* sells it to a consumer for $23.00. After 50 percent of use the tire proves defective and *N* sells a replacement tire to the consumer for $11.50 and *M* sells a replacement tire to *N* for $11.50. The above prices include an amount passed on as excise tax. The computation of tax would then be the weight of the tire (30 lbs.) times the price for the replacement tire sold by *M* ($11.50) divided by the regular price of the tire ($13.00) times the rate of tax (.10). Thus, $30 \times \frac{11.50}{13.00} \times .10 = \$2.65$ tax due on the sale of the replacement tire by *M* under method (2).

In *Situation 2*, *Z* determines the manufacturer of the defective tire who sold it under warranty to *Z*. That manufacturer, pursuant to such warranty, makes an adjustment to *Z* by either of the two methods. Even where the defective tire and the second tire sold to the consumer were not made by the same manufacturer, the adjustment made by *X* or *Y* satisfies the requirement for an adjustment in excise tax base under the principle of Rev. Rul. 59-394.

Accordingly, in *Situation 2*, method (1), since *X* or *Y* has granted *Z* a credit for the defective tire, the difference between the regular tax attributable to the type of tire used for replacement and the adjusted tax computed in the manner set forth in Rev. Rul. 59-394 will be allowed to *X* or *Y* as a credit against tax or as a refund. In method (2), the tax on the sale by *X* or *Y* to *Z* of another tire at a reduced price is also computed in the manner set forth in Rev. Rul. 59-394.

For example, a tire is sold by *X* (or *Y*) to *Z* for $13.00 and *Z* sells it to a consumer for $23.00. After 50 percent of use the tire proves defective and *Z* sells a replacement tire to the consumer for $11.50 and *X* (or *Y*) sells a replacement tire to *Z* for $6.50. The above prices include an amount passed on as excise tax. The computation of tax would then be the weight of the

tire (30 lbs) times the price for the replacement tire sold by *X* (or *Y*) ($6.50) divided by the regular price of the tire ($13.00) times the rate of tax (.10). Thus, $30 \times \frac{6.50}{13.00} \times .10 = \$1.50$ is the tax due on the manufacturer's sale of another tire to *Z* at a reduced price under method (2).

In *Situation 3* the pre-determined reduction in sales price is made by the manufacturer in lieu of selling its tires under a warranty. The dealer's payment in excess of this tire price to the manufacturer is repaid to the dealer in the form of tire adjustments and cash if there is a balance. The net effect of this system is that the dealer bears the risk and burden of the tire adjustments and the manufacturer's future liability on its defective tires is therefore eliminated.

Accordingly, since in *Situation 3* the manufacturer sells tires to the dealer at a price reduction and makes no warranty under which adjustments in price will actually be made by him if the tire proves defective, no adjustment in excise tax is allowable. See Rev. Rul. 68-400, 1968-2 C.B. 502, which relates to tires that are not manufactured under a private brand label.

Under the provisions of section 7805(b) of the Code, the conclusions in *Situation 1* only, will not be applied to adjustments of tires sold by manufacturers prior to October 1, 1977.

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26 CFR 48.4071-1: Imposition and rates of tax.
(Also Section 4072; 48.4072-1.)

Mini-bike tires; not suitable for highway use. Two-ply rated tires sold for use only on mini-bikes not designed or equipped for highway use are subject to the manufacturers tax of 5 cents a pound; Rev. Rul. 72-31 distinguished.

Rev. Rul. 76-434

Advice has been requested concerning application of the manufacturers excise tax on tires imposed by section 4071(a) of the Internal Revenue Code of 1954 to certain tires held out and sold for use only on mini-bikes.

A company manufactures pneumatic rubber tires that it holds out and sells for use only on mini-bikes that are not designed or equipped for operation on the highway. The tires range in size from 3.50 x 4 to 4.10 x 10 and are available in various tread designs. The tires are specially constructed by the manufacturer from lower quality chemical compounds, have fewer plies, not as strong cord construction, and a smaller bead bundle than tires it manufactures and sells for highway use. The tires in question have a two-ply rating (load range "A"), whereas similar size tires manufactured for highway use have at least a four-ply rating (load range "B"). Tests of the tires by the manufacturer demonstrate that they perform less favorably, especially at highway speeds, when compared to similar size tires manufactured for highway use.

Section 4071(a)(1) of the Code imposes a tax of ten cents a pound upon tires of the type used on highway vehicles, if wholly or in part of rubber, sold by the manufacturer, producer, or importer. Section 4071(a)(2) imposes a tax of five cents a pound upon other tires (other than laminated tires).

Section 48.4072-1(c)(1) of the Manufacturers and Retailers Excise Tax Regulations defines the term "tires of the type used on highway vehicles" as including (i) all tires of the type which are used on motor vehicles which are highway vehicles including but not limited to motor trucks, buses, passenger automobiles, highway tractors, trolley buses or coaches, and motorcycles, and (ii) all tires of the type which are used on vehicles of the type used in connection with highway motor vehicles including but not limited to truck or bus trailers and truck semitrailers.

Rev. Rul. 72-31, 1972-1 C.B. 337, considers whether certain pneumatic rubber tires that are held out and sold for use on mini-bikes are tires of the type used on highway vehicles. The tires range in size from 3.50 x 4 to 4.10 x 10 and are the same type that are used on certain highway-type trailers, such as camper, boat and baggage trailers. The ruling concludes that since in addition to their use on mini-bikes, the tires in question are also used on highway-type trailers, they are tires of the type used on highway vehicles and accordingly are subject to the tax of 10 cents a pound imposed by section 4071(a)(1) of the Code.

Rev. Rul. 57-218, 1957-1 C.B. 369, holds that the determination of the proper rate of the manufacturers excise tax on tires depends upon the "type" of the tires and not upon the actual use for which the tires are sold.

The tires in the present case, like those in Rev. Rul. 72-31, are of a size which would fit highway-type trailers. However, the factors of design and construction indicate that the tires are not suitable for highway use on such vehicles, but are only suitable for use on the mini-bikes not designed or equipped for highway use.

Therefore, the above-described tires are not tires of the type used on highway vehicles within the meaning of section 4071(a)(1) of the Code. Accordingly, such tires are subject to the tax of five cents a pound imposed by section 4071(a)(2).

Rev. Rul. 72-31 is distinguished.

Section 4072.—Definitions

26 CFR 48.4072-1: Definitions.

Whether certain tires that are held out and sold for use only on certain mini-bikes are tires of the type used on highway vehicles. See Rev. Rul. 76-434, above.

Subchapter F.—Special Provisions Applicable to Manufacturers Tax

Section 4216.—Definition of Price

26 CFR 148.1-5: Constructive sale price.

Constructive sale price; "cost" defined. For purposes of determining the constructive sale price of an article sold at retail by a manufacturer, the term "cost" includes all manufacturing, selling, and administrative expenses attributable to the article except those expenses relating to charges that are excludable from the sale price under section 4216(a) of the Code, and does not include expenses incurred solely by reason of the fact that the sales are at retail rather than wholesale; Rev. Ruls. 54-61, 62-173, 62-221, 68-202, 68-519, and 69-580 clarified.

Rev. Rul. 76-292

The Internal Revenue Service has been asked for further clarification of the meaning of the term "cost" as it is used in Revenue Rulings dealing with situations wherein the sale of a taxable article by a manufacturer, producer, or importer at retail necessitates the use of a constructive sale price in the computation of the manufacturers excise tax liability under section 4216(b)(1)(A) of the Internal Revenue Code of 1954.

Rev. Rul. 54-61, 1954-1 C.B. 259, Rev. Rul. 68-202, 1968-1 C.B. 477, Rev. Rul. 68-519, 1968-2 C.B. 513, and Rev. Rul. 69-580, 1969-2 C.B. 209, present formulas for arriving at such a constructive sale price in the situations discussed therein. In each of these formulas a computation of the cost to manufacture and sell the taxable article is pertinent.

Rev. Rul. 62-173, 1962-2 C.B. 249, holds that for purposes of computing the manufacturers excise tax in those cases in which a manufacturer's cost of taxable articles becomes relevant, cost should be determined in accordance with accepted accounting methods. Thus, the cost of the taxable articles should include all manufacturing, selling, and administrative expenses attributable to the articles except those expenses relating to charges that are excludable from the sale price under section 4216(a) of the Code. Rev. Rul. 62-221, 1962-2 C.B. 251, also refers to the term cost in a similar context.

Rev. Rul. 68-202 holds that in the case of a sale at retail, where the manufacturer sells only at retail, and has no "established retail price," the constructive sale price of chassis and bodies is the higher of: (1) 75 percent of the actual sale price, or (2) the "total cost" to manufacture and sell the chassis or body, plus ten percent. In any case where the price so constructed is more than the actual sale price, the actual sale price will be used.

The specific question is whether the term cost as used in the cited Revenue Rulings should include those costs and expenses incurred solely by reason of the fact that the sales in question are at *retail* rather than at wholesale.

Section 4216(b)(1)(A) of the Code provides that, if an article is sold at retail, the manufacturers excise tax 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 Secretary of the Treasury or the Secretary's delegate. The section further provides that such computation shall be on whichever of the following prices is the lower: (i) the price for which the article is sold, or (ii) the highest price for which such articles are sold to wholesale distributors, in the ordinary course of trade, by manufacturers or producers thereof, as determined by the Secretary or the Secretary's delegate.

Since the purpose of section 4216(b)(1)(A) of the Code is to construct a price that approximates the price at which the manufacturer (who only sells at retail) would sell to *wholesale* distributors it would be inconsistent with the statute to reflect in such a constructive price an amount representing a recovery by the manufacturer of expenses not ordinarily incurred by a manufacturer selling at wholesale.

Accordingly, as used in the Revenue Rulings cited herein, the term cost does not include retail expenses in excess of ordinarily incurred wholesale selling expenses. Thus, the term cost as used in those Revenue Rulings includes all manufacturing expenses, overhead expenses, and selling expenses to the extent they do not exceed ordinarily incurred wholesale selling expenses. Further, those expenses relating to charges that are excludable from the sale price under section 4216(a) of the Code are not included in the term cost.

Rev. Rul. 54-61, Rev. Rul. 62-173, Rev. Rul. 62-221, Rev. Rul. 68-202, Rev. Rul. 68-519, and Rev. Rul. 69-580 are clarified.

Section 4219.—Application of Tax in Case of Sales by Other Than Manufacturer or Importer

26 CFR 48.4219-1: Sales of taxable articles by a person other than the manufacturer, producer, or importer.
(Also Section 4061; 48.4061(a)-1.)

Liability for tax; successive nontaxable transfers after bankruptcy. The sale of taxable motor vehicles by an heir, to whom the vehicles were transferred by a decedent's estate that had acquired them as a secured creditor of the bankrupt vehicle manufacturer, is subject to tax to the same extent and in the same manner as if the heir were the manufacturer.

Rev. Rul. 76-492

Advice has been requested whether section 4219 of the Internal Revenue Code of 1954 applies to the transactions described below.

X company manufactured motor vehicle articles subject to the manufacturers excise tax imposed by section 4061(a)(1) of the Code. *X* went into bankruptcy and its assets were transferred to *A*, the trustee in bankruptcy. Under a court order, *A* transferred title to *X*'s assets to *B*, a decedent's estate holding a note secured by the

assets. The estate in due course transferred the assets to *C*, an heir. None of the foregoing transfers are sales for purposes of section 4061(a)(1). *C* sold the assets to *Y* company. The assets included finished motor vehicle articles subject to the tax imposed by section 4061(a)(1).

Section 4219 of the Code provides that in case any person acquires from the manufacturer, producer, or importer of an article, by operation of law or as a result of any transaction not taxable under chapter 32, the right to sell such article, the sale of such article by such person shall be taxable under chapter 32 as if made by the manufacturer, producer, or importer, and such person shall be liable for the tax.

Section 48.4219-1(a) of the Manufacturers and Retailers Excise Tax Regulations provides that if the title to, or ownership of, an article taxable under chapter 32 of the Code is transferred from the manufacturer, producer, or importer thereof, and, under the law, no tax attaches to such transfer, the subsequent sale, lease, or use of such article by the transferee is subject to tax to the same extent and in the same manner as if such transferee were the manufacturer, producer, or importer of the article. This section further provides examples to illustrate the rule, among which are a receiver or trustee in bankruptcy who under a court order conducts or liquidates the business of a manufacturer of taxable articles, or a person who acquires title to taxable articles as a result of default of the manufacturer pursuant to an agreement under the terms of which the articles were pledged as collateral. Each incurs liability for tax with respect to articles sold by such person.

In the instant case, title to *X*'s assets, including taxable motor vehicle articles, was transferred from *X* to *A*, the trustee in bankruptcy, by operation of law. Title to the assets was then transferred by *A*, the trustee, to *B*, the decedent's estate, and in turn to *C*, the heir, by operation of law. Therefore, by operation of law, *C* acquired from the manufacturer of taxable motor vehicle articles, *X*, the right to sell such articles as contemplated by section 4219 of the Code.

Accordingly, the sale of such articles by *C* to *Y* is subject to the manufacturers excise tax imposed by section 4061(a)(1) of the Code to the same extent and in the same manner af if *C* were the manufacturer of the articles.

Subchapter G.—Exemptions, Registrations, etc.

Section 4221.—Certain Tax-Free Sales

(Also Sections 4055, 4292.)

Exemptions; state university flying club. Articles sold to and communication services and facilities furnished to a state university flying club, operated under the control of the university and formed to provide members the opportunity to gain flying experience and to engage in discussions on subjects related to the field of aviation, are sold and furnished for the exclusive use of a state and come within the scope of the exemptions provided by sections 4055, 4221, and 4292 of the Code.

Rev. Rul. 76-509

Advice has been requested whether under the circumstances described below the exemptions from certain Federal excise taxes for states and other local governmental units provided by sections 4055, 4221(a)(4), and 4292 of the Internal Revenue Code of 1954 are applicable to sales of articles, and communication services and facilities furnished, to a flying club at a state university. (Effective February 1, 1977, the exemptions provided by sections 4055 and 4292 will be replaced by exemptions provided by new sections 4041(g)(2) and 4253(i), respectively. These changes were made by section 1904 of the Tax Reform Act of 1976, Pub. L. 94-455.)

The purposes of the flying club are to provide its members the opportunity to gain flying experience and to engage in discussions on subjects related to the field of aviation, along with occasional recreational activities. The club is capable of preparing an individual member for a pilot's license. The club's membership is composed of members of the faculty, staff, and student body. The officers and two faculty advisors are elected by the club members. The governing board of the club is comprised of the officers and four elected members. The chairman of the transportation department is an ex officio voting member of the board in the event of a deadlock.

Members of the club may purchase flight instruction given by university employees. All payments to the club account are for social and other club related activities as well as for use of the aircraft. The club rents aircraft owned and maintained by the university at a set hourly rate for aircraft operation.

The purposes for which the club was formed do not contemplate the distribution of gains, profits, or dividends to its members. Its constitution provides that the club operates under the control of the university, and that upon dissolution of the club, all assets will go to the department of transportation scholarship fund.

Section 4055 of the Code provides that the retailers excise taxes will not apply to the sale of any article for the exclusive use of any State, Territory of the United States, or any political subdivision of any of the foregoing, or the District of Columbia, or with respect to the use by any of the foregoing of any liquid as a fuel.

Section 4221(a)(4) of the Code provides that the manufacturers excise taxes will not apply to the sale by the manufacturer of an article to a State or local government for the exclusive use of a State or local government.

Section 4292 of the Code provides that no tax shall be imposed under section 4251 upon any payment received for communication services or facilities furnished to the Government of any State, Territory of the United States, or any political subdivision of the foregoing, or the District of Columbia.

Rev. Rul. 64-141, 1964-1 (Part 1) C.B. 391, holds that sales of articles to a student organization operated on the campus of a state college, under the authority of the education code of the state, are considered to be for the exclusive use of a state. Therefore, the sales come within the scope of the exemptions provided by sections 4055 and 4221(a)(4) of the Code with respect to the retailers excise taxes and the manufacturers excise taxes. Rev. Rul. 65-46, 1965-1 C.B. 500, holds that the services or facilities utilized by the student organization in the transaction of its official business come within the scope of the exemption provided by section 4292 of the Code.

Based on the facts in the instant case, articles sold to, and communications services and facilities furnished to, the university or the university flying club for the transaction of the official business of the flying club are sold and furnished for the exclusive use of a state. Accordingly, the exemptions provided by sections 4055, 4221(a)(4) and 4292 of the Code apply.

Whether irrigation districts of the State of California come within the scope of the exemption from the manufacturers excise taxes provided with respect to State and local governments. See Rev. Rul. 76-549, page 330.

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26 CFR 145.3-1: Tax free sales of school buses.

Whether the exemption from manufacturers excise tax provided by section 4221(e)(5) of the Code applies to the sale of a bus for use by the purchaser as a school bus for 60 percent of each year. See Rev. Rul. 76-555, page 344.

26 CFR 148.1-3: Temporary procedures for tax-free sales and purchases.

Tax-free sales for further manufacture; evidence. A manufacturer selling taxable articles tax-free to a purchaser for resale to a second purchaser for further manufacture may receive as proof of resale for further manufacture either a copy of the invoice issued by the first purchaser to the second purchaser or a statement of the availability of such invoice. Further, the invoice copy or statement must indicate the article was resold for further manufacture and include the registration numbers of each purchaser.

Rev. Rul. 76-305

Advice has been requested concerning the proof of resale for further manufacture required by section 4221(b)(1) of the Internal Revenue Code of 1954, for purposes of supporting tax-free sales under section 4221(a)(1).

A manufacturer of articles subject to the manufacturers excise taxes imposed under chapter 32 of the Code sells taxable articles to a purchaser for resale to a second purchaser for use in further manufacture of another article taxable under that chapter.

The specific question is whether a manufacturer may receive as proof of resale for further manufacture, either a copy of the invoice, issued by the first purchaser who resells to the second purchaser for further manufacture, or a statement where such copy is available.

Section 4221(a)(1) of the Code provides that no manufacturers excise tax shall be imposed under chapter 32 on the sale by the manufacturer of an article for use by the purchaser for further manufacture, or for resale by the purchaser to a second purchaser for use by such second purchaser in further manufacture, but only if such use is to occur before any other use.

Section 4221(b)(1) of the Code provides that where an article has been sold free of tax under section 4221(a)(1) for resale by the purchaser to a second purchaser for use by such second purchaser in further manufacture, section 4221(a)(1) shall cease to apply in respect of such sale of such article unless, within the 6-month period that begins on the date of the sale by the manufacturer (or, if earlier, on the date of shipment by the manufacturer), the manufacturer receives proof that the article has been resold for use in further manufacture. Under section 4222, section 4221(a)(1) shall not apply unless the manufacturer, the first purchaser, and the second purchaser (if any) are all registered under section 4222.

As evidence of a tax-free sale, section 148.1-3(f) of the Temporary Regulations under the Excise Tax Technical Changes Act of 1958 provides that the purchaser shall note on the purchase order, exemption certificate, or other document furnished to the seller by the purchaser the exempt purpose for which the article or articles are being purchased and the registration number assigned to the purchaser.

With respect to sales of articles for further manufacture, section 148.1-3(f) of the regulations sets forth the evidence required to support the manufacturer's tax-free sale to the first purchaser. Consistent with these regulations, where an article is resold by the first purchaser to a second purchaser for use in further manufacture, the second purchaser must furnish the first purchaser with the same evidence as to the purpose of the purchase and registration.

Similarly, in fulfilling the requirements of section 4221(b)(1) of the Code, the manufacturer may receive as proof of resale for further manufacture, a copy of the invoice the first purchaser has issued to the second purchaser, or a statement from the first purchaser that such copy is retained by the first purchaser and where it is available for inspection.

The copy or statement received by the manufacturer must include the registration numbers of the first and second purchasers and indicate that the article was in fact resold for use in further manufacture. Where the copy is retained by the first purchaser, it must also include the same information.

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26 CFR 148.1-3: Temporary procedures for tax-free sales and purchases.

Whether certain State associations of municipalities come within the scope of the manufacturers excise tax exemption provided with respect to State and local governments. See Rev. Rul. 76-550, page 331.

Chapter 33.—Facilities and Services
Subchapter B.—Communications

Section 4251.—Imposition of Tax

Whether a publication, relating to Government procurement matters, qualifies as the "public press" for purposes of the exemption from the communications tax under section 4523(b) of the Code. See Rev. Rul. 76-382, page 354.

Definition of the term "common carrier" for purposes of the exemption for common carriers and communications companies provided by section 4253(f) of the Code. See Rev. Rul. 76-405, page 352.

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26 CFR 49.4251-1: Imposition of tax.

Applicability of the communications tax to amounts paid by a radio station for certain toll telephone service. See Rev. Rul. 76-293, page 353.

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26 CFR 49.4251-1: Imposition of tax.

Whether a nonprofit home health organization with a child health center qualifies for the communication tax exemption provided for nonprofit hospitals. See Rev. Rul. 76-314, this page.

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26 CFR 49.4251-1: Imposition of tax.

Whether a nonprofit organization engaged in collecting, processing, storing and distributing blood, blood derivative, products, and related substances qualifies for the communication tax exemption provided for nonprofit hospitals. See Rev. Rul. 76-372, page 352.

26 CFR 49.4251-1: Imposition of tax.

The method described in Rev. Rul. 60-7 as to the procedure certain telephone companies must follow in reporting communication taxes on Form 720 is restated. See Rev. Rul. 76-560, page 392.

Section 4252.—Definitions

Definition of the term "common carrier" for purposes of the exemption from tax on the amount paid for toll telephone service described in section 4252(b)(2) of the Code. See Rev. Rul. 76-405, page 352.

Section 4253.—Exemptions

(Also Section 4251; 49.4251-1.)

Communications tax; home health organization. Neither a nonprofit community health organization, whose principal purpose is to provide nursing services in the home, nor its child health center operated as a secondary function qualifies as a nonprofit hospital for purposes of the communications tax exemption provided by section 4253(h) of the Code.

Rev. Rul. 76-314

The Internal Revenue Service has been asked whether, under the circumstances described below, the excise tax exemption provided by section 4253(h) of the Internal Revenue Code of 1954 for "nonprofit hospitals" applies to amounts paid for communication services.

A nonprofit organization is exempt from Federal income tax under the provisions of section 501(a) of the Code as an organization described in section 501(c)(3). Its articles of association state that a primary purpose of the organization is to serve the community as a home health agency.

The organization's main objective is to make available skilled nursing care and other therapeutic services on a visiting basis for the sick in their homes under the direction of their private physicians. It provides homemaker-home health aide services and medical social worker services. It assists in the prevention of disease and promotion of health through guidance and instruction in general areas of health information and knowledge. It furthers understanding and feeling for the value of a comprehensive health program and it coordinates its program with those of health and social agencies in the community for the benefit of individual, family, and community health. Medical supplies, wheelchairs, bed rails, walkers, and related equipment are kept at the organization's main location for the use of those it services. Individuals, by appointment, come to the organization to receive injections as specified by their physicians.

The organization also administers a child health center for the community at another location. A physician is the medical director of the center that is open for visits by appointment during the week. A child and youth program it conducts at the center provides comprehensive pediatric care through routine physical examinations, immunizations, and infant check-ups. Services are also provided when illness occurs. The center is staffed by pediatric nurse associates who function under the guidance of the medical director. Each of the two locations has its own phones and each location is billed separately by the phone company.

Section 4251 of the Code imposes a tax on amounts paid for local telephone service, toll telephone service, and teletypewriter exchange service.

Section 4253(h) of the Code provides that no tax shall be imposed under section 4251 on any amount paid by a nonprofit hospital for communications services furnished to such organization. For purposes of section 4253(h) of the Code, the term nonprofit hospital means a hospital referred to in section 170(b)(1)(A)(iii) that is exempt from income tax under section 501(a).

Section 170(b)(1)(A)(iii) of the Code describes an organization the principal purpose or functions of which are the providing of medical or hospi-

tal care or medical education or medical research, if the organization is a hospital.

Section 1.170A-9(c) of the Income Tax Regulations provides that a rehabilitation institution or an outpatient clinic may qualify as a hospital if its principal purpose or function is the providing of hospital or medical care.

The home health care organization does not come within the scope of section 170(b)(1)(A)(iii) of the Code as it is not a hospital, since its principal purpose is to provide nursing services in the home. Although the medical activity at the child health center is extensive it is nevertheless secondary to the primary purpose of the organization, which is that of a home health agency providing nursing care. Under the regulations, the child health center is not a hospital for purposes of the exemption from the tax on amounts paid for taxable communications services.

Further, there is no provision in section 4253(h) of the Code for treating an activity of an organization, which is described in section 501(c)(3) and exempt from income tax under section 501(a), as an independent unit that may qualify for exemption under section 4253(h) on its own. Compare section 4294(b), relating to the exemption from certain excise taxes of nonprofit educational organizations, that specifically authorizes the exemption to a school that is operated as an activity of an organization described in section 501(c)(3) that is exempt from income tax under section 501(a). See Rev. Rul. 76-9, 1976-1 C.B. 348, where the medical care function of a residential center was not treated as an independent unit for exemption qualification.

Accordingly, the exemption provided by section 4253(h) of the Code does not apply to any amount paid by the organization for taxable communications services furnished to the organization at the main location and at the child health center. Any amount paid for such communications services is subject to the tax imposed by section 4251(a).

(Also Section 4251; 49.4251-1.)

Communications; nonprofit blood bank. A blood bank, qualifying as a section 501(c)(3) organization, that supplies blood and components to hospitals exempt from the communications tax under section 4253(h) of the Code is not a hospital and does not qualify for exemption from the communications tax.

Rev. Rul. 76-372

The Internal Revenue Service has been asked whether, under the circumstances described below, the excise tax exemption, under section 4253(h) of the Internal Revenue Code of 1954, for "nonprofit hospitals" applies to amounts paid for communication services.

A nonprofit organization exempt from Federal income tax under the provisions of section 501(a) of the Code as an organization described in section 501(c)(3) is a blood bank, and as such is engaged in collecting, processing, storing and distributing blood, and the various blood derivatives, products, and related substances that are used in the treatment of sick and injured persons and the prevention of certain diseases. The board of trustees is composed of individuals representing the medical profession, hospitals, labor, industry, and the consumer.

The organization supplies blood and components to hospitals, including State hospitals and hospitals exempt under section 4253(h) of the Code. It has a laboratory for hepatitis testing, blood typing; and other related functions. The organization has several donor protection plans that guarantee blood if, when, and wherever needed.

Section 4251 of the Code imposes a tax on amounts paid for local telephone service, toll telephone service, and teletypewriter exchange service.

Section 4253(h) of the Code provides that no tax shall be imposed under section 4251 on any amount paid by a nonprofit hospital for communications services furnished to such organization, and that the term nonprofit hospital means a hospital referred to in section 170(b)(1)(A)(iii) which is exempt from income tax under section 501(a).

Section 170(b)(1)(A)(iii) of the Code describes an organization the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research, if the organization is a hospital.

The organization does not come within the scope of section 170(b)(1)(A)(iii) of the Code because its principal purpose or function is not the providing of medical or hospital care to patients, nor in any event is it a hospital. Accordingly, the organization does not qualify for the exemption provided by section 4253(h) with respect to the tax imposed by section 4251 on amounts paid for communications service.

(Also Sections 4251, 4252.)

Communications; exemptions; common carrier defined. For purposes of the exemption from tax on toll telephone service provided by section 4253(f) of the Code, a common carrier is one holding itself out to the public as engaged in the business of transportation of persons or property from place to place for compensation and offering its services to the public generally.

Rev. Rul. 76-405

The Internal Revenue Service has been asked to define the term "common carrier," as used in section 4253(f) of the Internal Revenue Code of 1954.

Section 4251(a) of the Code imposes a tax on amounts paid for local telephone service, toll telephone serv-

ice, and teletypewriter exchange service.

Section 4252(b)(2) of the Code defines the term "toll telephone service" to include a service that entitles the subscriber, upon payment of a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), to the privilege of an unlimited number of telephonic communications to or from all or a substantial portion of the persons having telephone or radio telephone stations in a specified area that is outside the local telephone system area in which the station provided with this service is located.

Section 4253(f) of the Code provides that no tax shall be imposed under section 4251 on the amount paid for any toll telephone service described in section 4252(b)(2) to the extent that the amount so paid is for use by a common carrier, telephone or telegraph company, or radio broadcasting station or network in the conduct of its business as such.

For the purpose of section 4253(f) of the Code a common carrier is one holding itself out to the public as engaged in the business of transportation of persons or property from place to place for compensation, offering its services to the public generally. The distinctive characteristic of a common carrier is that it undertakes to carry for all people indifferently. A common carrier is exempt from tax on the amount it pays for any toll telephone service described in section 4252(b)(2) of the Code to the extent that such service is used in the conduct of its business as such.

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26 CFR 49.4253-2: Exemption for news services.
(Also Section 4251; 49.4251-1.)

Communications; telephone service used in radio broadcasting. Long distance telephone calls made while on the air by announcers on radio news and "disc jockey" programs to newsworthy persons who are not representatives of news media organizations are not exempt from the communications tax on toll telephone service.

Rev. Rul. 76-293

Advice has been requested concerning the applicability of the exemption from the communications tax provided by section 4253(b) of the Internal Revenue Code of 1954, under the circumstances described below.

As a part of its programming format, a radio station broadcasts news and "disc jockey" programs. During such programs, the announcers make long distance telephone calls to newsworthy persons who are not representatives of news media organizations and conduct conversations with such persons on the air. Such telephone calls are "toll telephone service" within the meaning of section 4252(b)(1) of the Code.

Section 4251(a) of the Code imposes a tax on amounts paid for certain communication services, including toll telephone service.

Section 4252(b)(1) of the Code defines the term "toll telephone service" as meaning a telephonic quality communication for which (A) there is a toll charge which varies in amount with the distance and elapsed transmission time of each individual communication and (B) the charge is paid within the United States.

Section 4253(b) of the Code provides that no tax shall be imposed under section 4251, except with respect to local telephone service, on any payment received from any person for services used in the collection of news for the public press, or a news ticker service furnishing a general news service similar to that of the public press, or radio broadcasting, or in the dissemination of news through the public press, or a news ticker service furnishing a general news service similar to that of the public press, or by means of radio broadcasting, if the charge for such service is billed in writing to such person.

Section 49.4253-2(b) of the Facilities and Services Excise Tax Regulations provides that the exemption afforded by section 4253(b) of the Code applies to amounts charged for messages from any newspaper, press association, radio or television news broadcasting agency, or news ticker service, to any other newspaper, press association, radio or television news broadcasting agency, or news ticker service or to or from their bona fide correspondents, which messages deal exclusively with the collection of news items for, or the dissemination of news items through, the public press, radio or television broadcasting, or a news ticker service furnishing a general news service similar to that of the public press.

Pursuant to section 49.4253-2(b) of the regulations, the exemption provided by section 4253(b) of the Code with respect to news services applies only to amounts charged for messages from one member of the news media to another member of the news media, or to or from their bona fide correspondents.

The conclusion that the news services exemption applies only to amounts charged for those communications described in section 49.4253-2(b) of the regulations is supported by the legislative history of section 4253(b) of the Code. Representative Crisp, who offered the amendment that was the predecessor to section 4253(b) stated that:

***Under the bill as written certain press services, where they had leased lines, were exempted. There were many of the smaller newspapers which did not have these leased wires, and this is to give them the same exemption when the correspondents send in news. 75 *Cong. Rec.* 7145 (1932).

Thus, section 4253(b) was drafted specifically to provide an exemption for the communications described in section 49.4253-2(b) of the regulations.

In the instant case, all the *toll* telephone calls involved, whether by news-

casters or disc jockey announcers, are to persons who are not representatives of the news media organizations or their bona fide correspondents described in the regulations. Therefore, the exemption from the communications tax provided by section 4253(b) of the Code does not apply to amounts paid by the radio station for the above-described toll telephone service.

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26 CFR 49.4253-2: Exemption for news services.
(Also Section 4251.)

Communications; public press exemption. A publication concerned chiefly with specific items of information relating to Government procurement matters does not qualify as part of the public press for purposes of the exemption from the communications tax; Rev. Rul. 56-564 superseded.

Rev. Rul. 76-382 [1]

The purpose of this Revenue Ruling is to update and restate under the current statute and regulations the conclusion set forth in Rev. Rul. 56-564, 1956-2 C.B. 841. That Revenue Ruling relates to whether a certain publication qualifies as part of the "public press" for purposes of the exemption from the communications taxes provided by section 4253(b) of the Internal Revenue Code of 1954.

The periodical is printed in tabloid newspaper format. Most of the items contain brief and cryptic listings of United States Government procurement contracts open for bids at various procurement offices and listings of Government procurement contracts awarded. Space is also devoted to informational articles in narrative form and to display advertisements. Some of the narrative items relate to events or developments that were reported in the public press and were selected because of their bearing on Government procurement matters. Services and facilities subject to the communications excise tax are utilized in the collection of information and material disseminated through the publication.

Section 4251(a) of the Code imposes a tax on amounts paid for local telephone service, toll telephone service, and teletypewriter exchange service.

Section 4253(b) of the Code provides that no tax shall be imposed under section 4251, except with respect to local telephone service, on any payment received from any person for service used in the collection of news for the public press, or a news ticker service furnishing a general news service similar to that of the public press, or radio broadcasting, or in the dissemination of news through the public press, or a news ticker service furnishing a general news service similar to that of the public press, or by means of radio broadcasting, if the charge for such service is billed in writing to such person.

Section 49.4253-2(b)(2) of the Facilities and Services Excise Tax Regulations provides that the exemption does not extend to the collection and dissemination of information or matters for publication in magazines, periodicals, and trade and scientific publications issued to supply information on certain subjects of interest to particular groups.

Publications concerned chiefly with specific items of information such as those relating to Government procurement matters are of value only to individuals or groups that comprise narrow segments of the general public. The publication described herein lacks the characteristics and broader coverage of the public press, and does not disseminate news of general interest to the public at large. Accordingly, the exemption provided by section 4253(b) of the Code is not applicable to payments made for communication services or facilities used in the collection of information and material for dissemination in the above described publication.

Rev. Rul. 56-564 is hereby superseded, since the position set forth therein is restated under current law and regulations in this Revenue Ruling.

Subchapter C.—Transportation by Air
Part I.—Persons

Section 4261.—Imposition of Tax

(Also Sections 4041, 4281; 154.1-1.)

Air transportation; helicopter rental service. Hourly and flat rates, which included charges for layover time and movement of aircraft in deadhead service as well as for actual flight time, charged by a helicopter rental company for piloted helicopters having maximum certificated takeoff weights in excess of 6,000 pounds to a company for the transportation of employees to and from their job sites are subject to the tax imposed by section 4261 of the Code. Fuel used in such flights by helicopters having maximum certificated takeoff weights of 6,000 pounds or less is subject to tax under section 4041(c). Rev. Rul. 61-140 superseded.

Rev. Rul. 76-556

The purpose of this Revenue Ruling is to update and restate, under current law, the conclusions set forth in Rev. Rul. 61-140, 1961-2 C.B. 198. That Revenue Ruling relates to the application of the excise tax imposed by section 4261 of the Internal Revenue Code of 1954 to payments made to a helicopter rental company under certain circumstances for the transportation of persons. In updating that Revenue Ruling the Internal Revenue Service also has considered the application of the fuel tax under section 4041(c) and certain additional facts.

A helicopter rental company fur-

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[1] Prepared pursuant to Rev. Proc. 67-6, 1967-1 C.B. 576.

nishes helicopters with pilots to a company for the transportation of employees to and from job sites. The rental company does not provide regularly scheduled service. Flight services are conducted by the rental company as an independent contractor. The customer states the service it desires and the results to be obtained. The customer states the time, origin and destination, and number of passengers for each flight but does not control the manner or method of performance. No specific aircraft is designated for the use of the customer. Some of the aircraft provided have a maximum certificated takeoff weight of 6,000 pounds or less.

There are three ways of charging for the service; a basic hourly rate, a flat per diem rate plus a reduced hourly rate, and a flat thirty day rate plus a further reduced hourly rate. The customer is charged whichever rate is less. The rates include layover or waiting time and movement of the aircraft in deadhead service as well as actual flight time.

Section 4041(c) of the Code imposes a tax on gasoline and other liquids sold for use, or used, as fuel in an aircraft in noncommercial aviation.

Section 4041(c)(4) of the Code provides that for purposes of the fuel taxes the term "noncommercial aviation" means any use of an aircraft, other than use in a business of transporting persons or property for compensation or hire by air. The term also includes any use of an aircraft, in a business described in the preceding sentence, which is properly allocable to any transportation exempt from the taxes imposed by sections 4261 and 4271 by reason of section 4281 or 4282.

Section 4261(a) of the Code imposes a tax upon the amount paid for taxable transportation of any person by air. Section 4262(d) of the Code provides that the term "transportation" includes layover or waiting time and movement of the aircraft in deadhead service.

Section 4281 of the Code provides that the taxes imposed by sections 4261 and 4271 shall not apply to transportation by an aircraft having a maximum certificated takeoff weight of 6,000 pounds or less, except when such aircraft is operated on an established line.

The term "operation on an established line" is defined in section 49.4263-5(c) of the Facilities and Services Excise Tax Regulations to mean operated with some degree of regularity between definite points. The term does not necessarily mean that strict regularity of schedule is maintained; that the full run is always made; that a particular route is followed; or that intermediate stops are restricted. The term implies that the person rendering the service maintains and exercises control over the direction, route, time, number of passengers carried, etc.

Among the changes made by the Airport and Airway Revenue Act of 1970, section 4041(c) of the Code was amended to impose a fuel tax on noncommercial aviation; section 4262(d) was added to include in the term "transportation" layover or waiting time and movement of the aircraft in deadhead service; and section 4281 was added to provide exemption from the transportation taxes for certain small aircraft not operated on an established line.

Since the helicopter rental company retains possession, command and control over the aircraft at all times, it is selling a transportation service. See Rev. Rul. 76-394, this page. Therefore, in the instant case, amounts paid for the hourly, per diem and thirty day charges, with respect to aircraft that have a maximum certificated takeoff weight of more than 6,000 pounds, are subject to the tax imposed by section 4261 of the Code.

Further, in this case, the aircraft that have a maximum certificated takeoff weight of 6,000 pounds or less are not operated on an established line. Accordingly, the tax imposed by section 4261 of the Code does not apply. However, pursuant to section 4041(c)(4) the aircraft is used in noncommercial aviation and the taxes imposed by section 4041(c) apply on gasoline and other liquids sold for use, or used as fuel in such aircraft.

Rev. Rul. 61-140 is superseded since the position set forth therein is restated under current law in this Revenue Ruling.

Whether certain State associations of municipalities come within the scope of the exemption from the tax on amounts paid for transportation of persons by air. See Rev. Rul. 76-550, page 331.

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26 CFR 49.4261-1: Imposition of tax; in general.
(Also Section 4282.)

Transportation of persons by air. Situations illustrate whether amounts paid to a company by its wholly owned subsidiary and other companies in which its stockholders have a substantial interest, or a controlling interest and are officers and directors, under an agreement whereby the companies share in the operating expenses of an aircraft based on their percentage of use, are amounts paid for the transportation of persons by air for purposes of the tax imposed by section 4261 of the Code and whether such amounts come within the exemption from the tax provided by section 4282(a) for members of an affiliated group; Rev. Rul. 68-343 superseded.

Rev. Rul. 76-394

Advice has been requested whether the tax on the transportation of persons by air imposed by section 4261 of the Internal Revenue Code of 1954 applies to amounts paid in the situations described below.

Situation 1. In accordance with an

agreement between *X* company and several other companies, *X* company purchased an airplane with its own funds, took title to, and registered the plane in its own name. These companies, referred to as "participating" companies, include *X* company, its wholly-owned subsidiary, and several other companies in which the stockholders of *X* company have a substantial interest, ranging from 51 percent to 60 percent. The plane is used to transport, within the United States, only executive and managerial employees of the participating companies.

Situation 2. *X* company is the registered owner of an aircraft that it operates in connection with its business activities within the United States. In addition to being used by *X* company, the aircraft is used only to transport executives and employees of several other participating companies who are engaged in related business activities within the United States. These other companies have common officers and directors with *X* company, and the shareholders of *X* company have a controlling interest in the other companies.

In both *Situations 1* and *2*, the pilot, copilot, and mechanic for the aircraft are hired with the concurrence of each company but are on the payroll of *X* company. While the overall disposition of the aircraft is under the control of *X* company, the aircraft is operated at the direction of the particular company using the aircraft, subject to the discretion of the pilot as to safety requirements. Pursuant to a mutual agreement, each participating company shares in the annual operating expenses, which include the salaries of the pilot and crew, repairs, taxes, fuel, oil, insurance, and depreciation. Each company's share of operating expenses is computed by *X* company on the percentage of use of the aircraft by that company. Each of the companies other than *X* pays its share of the operating expenses to *X*. In both situations, the aircraft used has a maximum certificated takeoff weight of over 6,000 pounds.

The specific questions presented are (1) whether the payments received by *X* company in *Situations 1* and *2* are amounts paid for the transportation of persons by air for purposes of the tax imposed by section 4261 of the Code, and if so, (2) whether such amounts come within the exemption from the tax provided by section 4282(a) for members of an affiliated group.

Section 4261(a) of the Code imposes a tax on the amount paid for taxable transportation of any person by air. The tax imposed by that section, except in certain cases not here relevant, is to be paid by the person making payment for the service.

Section 4282(a) of the Code provides that, under regulations prescribed by the Secretary of the Treasury or his delegate, if (1) one member of an affiliated group is the owner or lessee of an aircraft, and (2) such aircraft is not available for hire by persons who are not members of such group, no tax shall be imposed under section 4261 or 4271 upon any payment received by one member of the affiliated group from another member of such group for services furnished to such other member in connection with the use of such aircraft. Section 4282(b) provides that for purposes of section 4282(a), the term "affiliated group" has the meaning assigned to such term by section 1504(a), except that all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)).

Section 1504(a) of the Code provides that the term "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) stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting 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 stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations. As used in that section, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

Rev. Rul. 60-311, 1960-2 C.B. 341, states that where the owner of a vehicle (such as a helicopter) leases it to others for the transportation of persons but retains the elements of possession, command, and control of the vehicle and performs all services in connection with the operation of the vehicle, he is furnishing a taxable transportation service within the meaning of section 4261 of the Code.

Rev. Rul. 68-343, 1968-1 C.B. 491, which sets forth similar facts as in *Situation 1*, concludes that where several participating companies, in order to transport their executive and managerial personnel within the United States, use an airplane owned by one of the companies which also furnishes the pilot, amounts paid to the owner-company by the other participating companies as to their share of the operating expenses are amounts paid for taxable transportation of persons by air for purposes of the tax imposed by section 4261(a) of the Code.

Since in each situation the title and registration of the aircraft is in the name of *X* company as owner of the aircraft, and the pilot and crew are on *X*'s payroll, *X* company is deemed to have the essential elements of possession, command and control of the plane at all times, irrespective of the fact that the other participating companies may direct the pilot as to destination and other details concerning actual flights when they are using the plane. Therefore, *X* company in each situation is furnishing a transportation service to the other participating com-

panies, and payments made by the other participating companies for their respective shares of the operating expenses are amounts paid for transportation service.

As to the remaining question of whether the exemption provided by section 4282(a) of the Code applies in *Situation 1*, *X* and its wholly-owned subsidiary are members of an affiliated group as defined in section 1504(a). However, the other companies are not members of the affiliated group since ownership of the companies is by *X*'s stockholders and not by *X* or its wholly-owned subsidiary. Therefore, the use of the airplane by the other participating companies is use by persons who are not members of the affiliated group and thus the restricted use of the airplane as required by section 4282(a) is not met.

In *Situation 2*, the facts indicate that rather than the voting power or stock ownership being vested in one or more of the companies, the ownership of the companies vests in the individual shareholders who hold a common interest in all the companies and there is no common parent company. Therefore, *X* company and the other participating companies using the aircraft are not an affiliated group within the meaning of section 1504(a) of the Code and the exemption provided by section 4282(a) is not applicable.

Accordingly, in both *Situations 1* and *2*, amounts paid to *X* company by the other companies with respect to their use of the aircraft are subject to the tax imposed by section 4261(a) of the Code.

Rev. Rul. 68-343 is amplified and, as amplified, is superseded since the position set forth in that Revenue Ruling is restated in this Revenue Ruling under current law.

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26 CFR 49.4261-1: Imposition of tax; in general.

Applicability of the tax on the transportation of persons by air in the case of an aircraft used by the shareholders of a corporation that was created by them to own and maintain the aircraft, for which use the shareholders are charged an amount based either on an hourly rate or miles flown. See Rev. Rul. 76-431, page 328.

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26 CFR 49.4261-1: Imposition of tax; in general.

Whether the tax on transportation of persons by air applies to amounts paid for administrative flying, fire detection, fire reconnaissance, and fire suppression at public land forest locations. See Rev. Rul. 76-477, page 329.

Part II.—Property

Section 4271.—Imposition of Tax

26 CFR 154.2-1: Tax on transportation of property by air.

Applicability of the tax on the transportation of property by air in the case of an aircraft used by the shareholders of a corporation that was created by them to own and maintain the aircraft, for which use the shareholders are charged an amount based either on an hourly rate or miles flown. See Rev. Rul. 76-431, page 328.

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26 CFR 154.2-1: Tax on transportation of property by air.

Whether the tax on transportation of property by air applies to amounts paid for administrative flying, fire detection, fire reconnaissance, and fire suppression at public land forest locations. See Rev. Rul. 76-477, page 329.

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26 CFR 154.2-1: Tax on transportation of property by air.

Whether certain State associations of municipalities come within the scope of the exemption from the tax on amounts paid for transportation of property by air. See Rev. Rul. 76-550, page 331.

Part III.—Special Provisions Applicable to Taxes on Transportation by Air

Section 4281.—Small Aircraft on Nonestablished Lines

Whether exemption applies to amounts paid for transportation by aircraft of employees to and from oil wells sites when a per diem rate is charged plus an additional fixed hourly charge for actual flying time. See Rev. Rul. 76-556, page 354.

Section 4282.—Transportation by Air for Other Members of Affiliated Group

Whether exemption from the tax on transportation of persons for an affiliated group applies in two situations involving amounts paid by a group of corporations to another related corporation for the use of an aircraft. See Rev. Rul. 76-394, page 355.

Subchapter E.—Special Provisions Applicable To Services and Facilities Taxes

Section 4292.—State and Local Governmental Exemption [Repealed by section 1904(a)(9) of Public Law 94-455, effective February 1, 1977.]

Applicability of the exemption from tax where communications services or facilities are furnished to a state university flying club. See Rev. Rul. 76-509, page 349.

Whether irrigation districts of the State of California come within the scope of the exemption from the communcation services and facilities excise taxes with respect to States and political subdivisions thereof. See Rev. Rul. 76-549, page 330.

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26 CFR 148.1-3: Temporary procedure for tax-free sales and purchases.

Whether certan State associations of municipalities come within the scope of the exemption from the communication services and facilities excise taxes. See Rev. Rul. 76-550, page 331.

Chapter 34.—Policies Issued by Foreign Insurers

Section 4371.—Imposition of Tax

26 CFR 46.4371-2: Imposition of tax on policies issued by foreign insurers; scope of tax.
(Also Sections 4372, 4374; 46.4374-1.)

Foreign insurance policies; shipowners assurance associations. Application for and acceptance of membership in a foreign mutual assurance association of shipowners who enter their ships in the association for protection and/or indemnity purposes constitute a contract of casualty insurance

within the meaning of section 4371 of the Code. Advance calls and supplemental calls paid at the beginning of and during each contract year, based on estimated liabilities and expenses and adjusted at the end of each year, constitute premiums paid and are subject to tax only when the amount due for the year is finally determined. Rev. Rul. 57-406 superseded.

Rev. Rul. 76-447

Advice has been requested as to the applicability of the tax on foreign insurance policies imposed by section 4371 of the Internal Revenue Code of 1954, to contracts entered into and amounts paid under the circumstances described below.

Various foreign associations of shipowners that are mostly unrelated are organized for the purpose of providing protection or indemnity to its members. Some of these associations are known as protection or indemnity "clubs" while others are referred to as mutual underwriting or assurance associations. The shipowners in these associations contract through the associations to share risks, such as (1) loss of, or damage to, their own vessels (including any property on board), (2) costs and expenses arising out of collision between their own vessels and other vessels, and (3) liabilities that members of the associations may incur with respect to loss of life and personal property. In order to meet claims and obligations arising from the risks assumed, the associations require each member to make payments to a fund set aside and earmarked for these purposes. The amounts required to be paid by members are usually referred to as "calls."

Generally, in the type of association described above, a shipowner makes application for membership, and upon acceptance by the association enters his vessel or vessels in the association and receives a "certificate of entry" for each vessel entered. An entry fee is usually required to ensure membership. The shipowner is then subject to periodic calls. At the beginning of each contract year, advance calls based on estimated liabilities and expenses are collected from each member. If a deficiency in the association's fund develops, supplemental calls are collected during, or at the close of, the year. In addition, most contracts between the associations and their members provide that where a member's vessel is laid up in a safe port for a certain number of consecutive days or more during the year, the member will receive a return in the amount of a certain percentage of the calls he has paid in for that year. Consequently, in all of these associations, the amount of each member's total calls and the amount of any return of calls is not determinable until all losses, liabilities, and expenses, as well as any layover time, are taken into account at the close of the year.

Section 4371(1) of the Code imposes a tax on each policy of casualty insurance or an indemnity bond issued by a foreign insurer or reinsurer, if issued to or for, or in the name of, an insured as defined in section 4372(d). Section 4371 further provides that if the tax is paid on the basis of a return under regulations prescribed under section 4374, the tax is to be computed on the premium paid in lieu of the premium charged.

Section 46.4374-1(a) of the Regulations Relating to Miscellaneous Excise Taxes Payable by Return provides that in the case of premiums paid on or after January 1, 1966 the tax imposed by section 4371 of the Code shall be paid on the basis of a return. Such tax is to be remitted by the person who makes the payment of the premium to a foreign insurer or reinsurer or to any nonresident agent, solicitor, or broker.

Section 4372(b) of the Code provides that the term "policy of casualty insurance" means any policy (other than life) or other instrument by whatever name called whereby a contract of insurance is made, continued, or renewed.

Under section 4372(d) of the Code the term "insured" means (1) a domestic corporation or partnership or an individual resident of the United States, against, or with respect to hazards, risks, losses, or liabilities wholly or partly within the United States, or (2) a foreign corporation, foreign partnership or nonresident individual, engaged in a trade or business within the United States, against or with respect to hazards, risks, losses, or liabilities within the United States.

Section 46.4371-3(a) of the regulations provides that the tax under section 4371 of the Code is imposed at the current applicable rate on the premium payment. Section 46.4371-3(b) provides that the term "premium payment" means the consideration paid for assuming and carrying the risk or obligation, and includes any additional assessment or charge paid under the contract, whether payable in one sum or installments.

Rev. Rul. 57-406, 1957-2 C.B. 776, relates to a foreign mutual assurance association of shipowners who enter their ships in the association for protection or indemnity. That Revenue Ruling concludes that the application for membership and acceptance thereof by the association creates a contract of insurance between the association, a foreign insurer, and its members.

Rev. Rul. 69-101, 1969-1 C.B. 290, concludes that an amount deposited in lieu of a premium is not a "premium paid" within the meaning of section 4371 of the Code, and is not subject to the tax imposed by that section until such time as the premium has been determined. That Revenue Ruling further concludes that if tax is paid on such deposits and the premium as later determined is less than the deposit, a credit or refund of tax is allowable.

The questions presented are (1) whether the contracts described above are policies of casualty insurance

within the meaning of section 4371(1) of the Code and if so, (2) whether the calls when collected by the associations from "insured" members (as defined in section 4372(d)) are "premiums paid" for purposes of the tax imposed by section 4371(1).

With respect to the first question the applications for membership and the acceptance thereof by the associations create contracts of casualty insurance within the meaning of section 4371(1) of the Code.

As to the remaining question of whether advance calls and supplemental calls when collected by the associations from "insured" members are premiums paid for purposes of the tax, the facts indicate that the total amount required to be paid in by a member to an association for a particular policy year is not determinable at the beginning of the year but depends upon events and contingencies that may occur throughout the year. Thus, it is anticipated that adjustments will be made at the end of the year with respect to amounts actually collected from each member during the year. Accordingly, advance calls and supplemental calls collected during the year are considered to be "amounts deposited in lieu of the policy premium" within the meaning of Rev. Rul. 69-101 until such time as all claims, losses, expenses, other liabilities, and layovers have been taken into account at the end of the year. At that time, the amount finally determined to be due for the policy year from each "insured" member constitutes the premium paid and is subject to the tax imposed by section 4371 of the Code. If, in any case, tax is paid on the calls, and the premium as later determined is less than the calls, a credit or refund of tax is allowable.

Rev. Rul. 57-406 is hereby superseded, inasmuch as any conclusions contained therein that are still applicable are incorporated and restated in this Revenue Ruling.

Section 4372.—Definitions

Applicability of the tax on foreign insurance policies to contracts between associations of foreign shipowners and their members. See Rev. Rul. 76-447, page 357.

Section 4374.—Payment of Tax

26 CFR 46.4374-1: Payment of tax.

Applicability of the tax on foreign insurance policies to amounts paid as "advance calls" and "supplemental calls" by members of foreign associations of shipowners. See Rev. Rul. 76-447, page 357.

Chapter 36.—Certain Other Excise Taxes
Subchapter B.—Occupational Tax on Coin-Operated Devices

Section 4461.—Imposition of Tax

Whether the tax on coin-operated gaming devices applies to pinball machines used without charge in tournaments in which prizes are awarded. See Rev. Rul. 76-557, page 360.

26 CFR 45.4461-1: Imposition of tax.

Whether the tax on coin-operated gaming devices applies to a certain "music machine." See Rev. Rul. 76-306, below.

Section 4462.—Definition of Coin-Operated Gaming Device

26 CFR 45.4462-1: Definition of coin-operated gaming device.
(Also Section 4461; 45.4461-1.)

Coin-operated devices; juke box. A juke box that sometimes offers a player depositing a coin for 2 record selections the opportunity to deposit another coin and receive the right to make 2 to 8 "bonus" selections that cannot be converted to cash, tokens, or merchandise is not a coin-operated gaming device for purposes of the occupational tax imposed by section 4461(a) of the Code.

Rev. Rul. 76-306

Advice has been requested whether a certain "music machine" is a coin-operated gaming device for purposes of the occupational tax imposed by section 4461(a) of the Internal Revenue Code of 1954.

The machine is similar to the commonly known "juke box" in that two phonograph records may be selected and played for each deposit of a coin. However, it has an additional feature that operates in cycles so that the machine sometimes provides the player, immediately after making the initial deposit, with an opportunity to make another deposit and receive the right to make 2, 4, 6, or 8 more selections for the second deposit in addition to the right to make the two selections purchased with the first deposit.

The right to receive the "bonus play" will be illuminated on the machine, but the player need not exercise that right. The player can reject it by making two selections for the initial deposit. If the bonus play is utilized, the player will always receive at least two selections for each deposit.

The extra plays cannot be converted to cash, tokens, or merchandise. If the extra selections are not made, the machine will automatically replay the last selection made for the number of extra selections to be used. The machine does not have a meter for keeping a total of the number of additional selections provided by the machine. Additionally, the bonus plays cannot be cancelled from the machine.

Section 4461(a) of the Code imposes a special tax to be paid by every person who maintains for use or permits the use of, on any place or premises occupied by such person, a coin-operated gaming device as defined in section 4462.

As defined in section 4462(a)(1) of the Code, a "coin-operated gaming device" includes a so-called "slot" machine that operates by means of the insertion of a coin, token, or similar object and which, by application of the element of chance, may deliver, or entitle the person playing or operating the machine to receive, cash,

premiums, merchandise, or tokens. Section 4462(b) provides that the term coin-operated gaming device does not include a bona fide vending or amusement machine in which gaming features are not incorporated.

Section 45.4462-1(a)(2)(i) of the Miscellaneous Stamp Tax Regulations provides that a coin-operated gaming device includes a machine that has the features and characteristics of a gaming device whether or not evidence exists as to actual payoffs.

The possibility that a limited number of free plays may be won is not, standing alone, a feature or characteristic that renders a machine peculiarly adapted to use for gaming purposes when the maximum number of plays that may be won does not exceed the number that a person playing the machine merely for amusement would normally play off. Compare Rev. Rul. 60-102, 1960-1 C.B. 555, which holds that a pinball machine that is so designed that the insertion of additional coins increases the chances of winning a high score and that registers free plays far in excess of the number that a person playing for amusement normally would play off, is a coin-operated gaming device. Compare also *United States v. One Bally "Barrel-O-Fun,"* 224 F. Supp. 794 (M.D. Pa. 1963), *aff'd per curiam sub nom.* 337 F. 2d 857 (3rd Cir 1964), where the large number of free plays that could be won on the pinball machines in question was described by the court as one of the most important factors leading to the conclusion that the machines were coin-operated gaming devices.

Accordingly, the machine described above is not a coin-operated gaming device within the meaning of section 4462(a)(1) of the Code and no liability for the occupational tax imposed by section 4461(a) is incurred with respect to its maintenance for use.

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26 CFR 45.4462-1: Definition of coin-operated gaming devices.
(Also Section 4461.)

Pinball machines. Pinball machines that are used, free of charge, in tournaments in which prizes are awarded for the highest score are not coin-operated gaming devices subject to the occupational tax imposed by section 4461(a) of the Code; Rev. Rul. 76-25 distinguished.

Rev. Rul. 76-557

Advice has been requested whether a nontaxable pinball machine used under the circumstances described below becomes a coin-operated gaming device for purposes of the occupational tax imposed by section 4461(a) of the Internal Revenue Code of 1954.

A taxpayer that maintains nontaxable coin-operated pinball machines at several of its places of business for use by customers, sponsors a free pinball tournament in which players compete for prizes. Winners are determined on the basis of the highest scores attained during tournament play. These pinball machines, when used in the tournament, are operated without insertion of a coin. There is no charge or payment made for the privilege of operating a machine during the tournament, nor is there an entry fee required for participation.

Section 4461(a) of the Code imposes a special annual tax to be paid by every person who maintains for use or permits the use of, on any place or premises occupied by such person, a coin-operated gaming device as described in section 4462.

As defined in section 4462(a)(2) of the Code, a coin-operated gaming device includes a machine similar to a so-called "slot" machine that operates without the insertion of a coin, token, or similar object and which, by application of the element of chance, may deliver, or entitle the person playing or operating the machine to receive, cash, premiums, merchandise, or tokens.

Section 45.4462-1(a)(2) of the Miscellaneous Stamp Tax Regulations illustrates the type of devices within the scope of section 4462(a) of the Code. Included are pinball machines equipped with a push button for releasing free plays and a meter for recording the plays so released, or equipped with provisions for multiple coin insertion for increasing odds. Also included are pinball machines in connection with which free plays are redeemed in cash, tokens, or merchandise, or prizes are offered to any person for the attainment of designated scores.

Rev. Rul. 76-25, 1976-1 C.B. 349, relates to the taxability of a coin-operated pinball machine where prizes are awarded to players based on the highest weekly score. It holds that where the highest weekly score is designated as a winning score the pinball machine is a coin-operated gaming device.

The term "coin operated" as used in the law and regulations means that payment, in some form, will be made in connection with the operation of the machine.

In the instant case no payment is made, directly or indirectly, for the privilege of operating the pinball machines used in the tournament. Accordingly, since there is no consideration paid, the machines do not become coin-operated gaming devices within the meaning of section 4462(a) of the Code when used in the tournament and the taxpayer is not liable for the tax imposed by section 4461(a).

Rev. Rul. 76-25 is distinguished.

Subchapter D.—Tax on Use of Certain Vehicles

Section 4481.—Imposition of Tax

26 CFR 41.4481-1: Imposition of tax.
(Also Section 4482; 41.4482(b)-1.)

Highway use tax; trucks equipped to tow two-axled trailer. Each of a beverage company's two-axled beverage trucks, with actual unloaded weights ranging from 9,000 to 13,000 pounds, equipped with

beverage-type bodies and pintle hooks and customarily used for towing two-axled beverage trailers fall within the truck-trailer combination category for purposes of the highway use tax, even though the pintle-hook equipped trucks are twice the number of two-axled trailers owned by the company.

Rev. Rul. 76-558

Advice has been requested whether a company's beverage trucks equipped with pintle hooks fall within the single unit category or the truck-trailer combination category for purposes of the tax imposed on the use of highway motor vehicles by section 4481(a) of the Internal Revenue Code of 1954.

A beverage company operates 40 trucks used to transport beverages over the public highways. The trucks have 2 axles, beverage-type bodies, and actual unloaded weights ranging from 9,000 pounds to 13,000 pounds for Federal highway use tax purposes. Twenty of the trucks are equipped with pintle hooks and are used for towing trailers whenever larger deliveries are required. The trailers have 2 axles, beverage-type bodies, empty weights ranging from 4,500 pounds to 6,000 pounds, and gross vehicle weight ratings of from 9,000 pounds to 12,000 pounds. The company operates 10 of these trailers.

Section 4481(a) of the Code imposes a tax upon the use of any highway motor vehicle which (together with the semitrailers and trailers customarily used in connection with highway motor vehicles of the same type as such highway motor vehicle) has a taxable gross weight of over 26,000 pounds.

Section 4482(b) of the Code provides that taxable gross weight shall be determined under regulations prescribed by the Secretary of the Treasury or the Secretary's delegate (which regulations may include formulas or other methods for determining the taxable gross weight of vehicles by classes, specifications, or otherwise).

Section 41.4482(b)-1(d) of the Highway Motor Vehicle Use Tax Regulations prescribes a schedule of taxable gross weights for periods after June 30, 1969. For purposes of determining the taxable gross weight of a highway motor vehicle, the schedule divides trucks into single units and truck-trailer combinations.

In the single unit category is any truck designed for the transportation of property, and which is not equipped to tow a trailer or semitrailer of the type that forms a "combination" when coupled with a truck. In the truck-trailer combination category is any truck designed primarily for the transportation of property, and which is equipped for towing trailers or semitrailers of the type that form a combination when coupled with a truck, if trucks of the same type, when so equipped, are customarily used to tow such trailers or semitrailers. Trailers having two or more axles, and one-axled trailers with a gross weight (as defined in section 142.1-1(d)(3) of the Temporary Excise Tax Regulations under the Revenue Act of 1971) of 6,000 pounds or more, are trailers of the type that form a combination when coupled with a truck. See Rev. Rul. 76-294, page 364, this Bulletin. Since the beverage trailers in the instant case have two axles, they are trailers of the type that form a combination with a truck.

In determining whether a truck is a "single unit" or "truck-trailer combination" for purposes of the use tax schedule, the amount of actual use of a trailer with the truck is not a factor. A truck equipped for use with combination-type trailers falls within the "combination" category even though it is operated without a trailer at the time it is first used on the highway during a taxable year. See the case of *North American Van Lines v. United States,* 169 Supp. 252, in which the U.S. Court of Claims stated in part as follows:

* * * Congress in section 4482 relieved the taxing authorities of the probably impossible task of actually weighing the equipment and loads by writing a definition of "taxable gross weight" which permitted generalization by the taxing authorities. They could tax as if there were a trailer of the kind "customarily used in connection with" the tractor, and as if it were loaded with "the maximum load customarily carried" on such a trailer by such a tractor.

The facts in the instant case indicate that beverage trucks equipped with pintle hooks are equipped to tow 2-axled beverage trailers. Therefore, such trucks are customarily used with trailers of the type intended by the term "combinations." It is immaterial that there are more such trucks than trailers and that such trucks may frequently be operated on the highway without trailers.

Accordingly, each of the company's 20 beverage trucks that is equipped with a pintle hook falls within the truck-trailer combination category of the schedule of taxable gross weights, for purposes of the tax imposed by section 4481(a) of the Code.

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26 CFR 41.4481-1: Imposition of tax.

Classification of certain utility trucks for purposes of the highway use tax imposed by section 4481(a) of the Code. See Rev. Rul. 76-294, page 364.

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26 CFR 41.4481-1: Imposition of tax.

Whether the use of highway motor vehicles by the American National Red Cross is exempt from the tax imposed on the use of certain highway motor vehicles by section 4481(a) of the Code. See Rev. Rul. 76-510, page 366.

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26 CFR 41.4481-1: Imposition of tax.

Whether certain vehicles fall within the truck, tractor-trailer combination, or truck-trailer combination categories for purposes of the highway use tax imposed by section 4481 of the Code. See Rev. Rul. 76-559, page 365.

Section 4482.—Definitions

26 CFR 41.4482(b)-1: Definition of taxable gross weight.

Highway use; packer-type refuse

truck. A packer-type refuse truck's tailgate assembly and ejection panel parts, exclusive of the tailgate shell and packing panel, are not included in determining actual unloaded weight for highway use tax purposes; Rev. Rul. 57-340 amplified.

Rev. Rul. 76-263

Advice has been requested whether the weight of certain tailgate assembly and ejection panel parts may be excluded in computing the actual unloaded weight of rear loading packer-type refuse collection trucks for purposes of the highway motor vehicle use tax imposed by section 4481 of the Internal Revenue Code of 1954. The parts are listed below.

Item 1. Hopper.—This is a bin into which refuse is placed in the loading process.

Item 2. Sweeper panel. — This panel is positioned above the hopper and clears the hopper of refuse by making a 360 degree rotation to a point level with the body floor. The panel does not support or contain the load of the vehicle while it is in transit.

Item 3. Packing panel.—The panel clears the refuse from the hopper or the sweeper panel when level, depending on the truck model, and pushes the refuse into the body under pressure. The packing panel also supports and contains the load of the vehicle while it is in transit and serves as part of the rear exterior wall of the truck.

Item 4. Hydraulic system and gears.—These serve to operate the various panels and to raise and lower the tailgate to permit unloading of the truck. These also serve to lock the various panels into place when the vehicle is in transit.

Item 5. Tailgate shell.—This is the exterior shell that houses the parts listed above as *Items 1, 2 and 4* and helps contain the load of the truck, but performs no function in handling, loading, or unloading cargo.

Item 6. Ejection panel and cylinders.—The ejection panel provides resistance against the pressure action of the packing panel to compress the refuse as it is loaded. As the loading progresses, the panel moves from the rear to the front of the body. This panel helps contain the load of the vehicle while it is in transit. However, the vehicle has a complete front body wall. In the unloading cycle, the cylinders power the ejection panel to the rear of the body to eject the load.

Section 4481 of the Code imposes a tax on the use of any highway motor vehicle which has a taxable gross weight of more than 26,000 pounds.

As defined in section 4482(b) of the Code, the term "taxable gross weight" means the sum of (1) the actual unloaded weight of the highway motor vehicle fully equipped for service, and the semitrailers and trailers (fully equipped for service) customarily used in connection with highway motor vehicles of the same type as such highway motor vehicle, and (2) the weight of the maximum load customarily carried on highway motor vehicles of the same type, and on the trailers and semitrailers.

In the case of trucks and truck-tractors, section 41.4482(b)-1(b) of the Highway Motor Vehicle Use Tax Regulations defines the term "fully equipped for service" as including the body; all accessories; all equipment attached to or carried on the truck or truck-tractor for use in connection with the movement of the vehicle by means of its own motor or for use in the maintenance of the vehicle; and a full complement of lubricants, fuel, and water. However, the regulation also provides that the term does not include driver, any equipment (not including body) attached to or carried on the vehicle for use in handling, protecting, or preserving cargo; or any special equipment (such as an air compressor, crane, specialized oilfield machinery, etc.) mounted on the vehicle for use on construction jobs, in oilfield operations, etc.

Rev. Rul. 57-340, 1957-2 C.B. 786, in interpreting section 41.4482(b)-1 (b) of the regulations, states that any equipment mounted on or attached to a single-unit highway motor vehicle that is not a part of the body and performs no function in the operation or maintenance of the vehicle, but is used only in loading, unloading, protecting, or preserving the cargo, is not to be included in determining actual unloaded weight.

Among the articles considered in Rev. Rul. 57-340 are hydraulic lift gates mounted on trucks to facilitate the handling of heavy articles. The Revenue Ruling holds that where, in addition to raising or lowering the load, the gate serves as a tail gate for a vehicle, it is a part of the body and its weight must be included in determining the actual unloaded weight.

Equipment of the type that would not be on a vehicle except for its use in loading, unloading, protecting, or preserving cargo is not to be included in determining actual unloaded weight merely because it performs some incidental function that in the absence of such equipment could be performed by another part of the vehicle or by the addition of minor equipment.

Items 1 (hopper) and *2* (sweeper panel) are solely designed to perform loading, unloading and handling functions. Therefore these items are not to be included in computing the actual unloaded weight of the vehicle.

Item 3 (packing panel) performs a loading function, but also performs a significant function in containing the load. In the absence of the packing panel, there would be nothing to keep the refuse from falling off the back of the vehicle. This item serves as part of the rear exterior wall of the vehicle and thus is a part of the body of the vehicle. *Item 3* is analogous to the hydraulic lift gate described in Rev. Rul. 57-340 that is a part of the body of the vehicle since it also serves

as a tailgate. Therefore, *Item 3* must be included in computing the actual unloaded weight of the vehicle.

Item 4 (hydraulic system and gears) is designed primarily to operate in connection with the loading and unloading function and only incidentally serves to lock the various panels into place when the vehicle is in transit. This incidental function could be performed in the absence of *Item 4* by the addition of a few hinges and bolts. Therefore, *Item 4* is not to be included in computing the actual unloaded weight of the vehicle.

Item 5 (tailgate shell) performs a function in containing the load of the vehicle and performs no loading or unloading function. This exterior shell is a part of the body of the vehicle. Therefore, *Item 5* must be included in computing the actual unloaded weight of the vehicle.

In connection with *Item 6* (ejection panel and cylinders), the cylinders support the ejection panel, and the ejection panel contains the trash (load) in the sense that the trash is pushed against the panel as it is loaded into the truck. However, *Item 6* primarily performs a loading and unloading function and only incidentally contains the load, since the vehicle has a complete front body wall. Therefore, *Item 6* is not to be included in computing the actual unloaded weight of the vehicle.

See Rev. Proc. 66-15, 1966-1 C.B. 529, for a standard weight exclusion factor that will be accepted by the Internal Revenue Service in lieu of actual identification and substantiation of parts in determining the "actual unloaded weight" of rear loading packer-type refuse collection trucks.

The hydraulic system and gears, *Item 4* above, are similar to a hydraulic power system required to operate the hydraulic lift gate in Rev. Rul. 57-340. While the hydraulic power system is not mentioned as a separate item in Rev. Rul. 57-340, it should be excluded from actual unloaded weight as it does not perform any significant function other than in connection with loading and unloading.

Rev. Rul. 57-340 is amplified to conclude that the hydraulic power system for a hydraulic lift gate is not to be included in determining actual unloaded weight of the vehicle.

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26 CFR 41.4482(b)-1: Definition of taxable gross weight.

Highway use; dump truck with hydraulic hoist. A dump truck's hydraulic hoist that, in addition to being used for unloading the cargo, anchors the dump body to the chassis is not included in determining the truck's actual unloaded weight for highway use tax purposes; Rev. Rul. 57-615 revoked.

Rev. Rul. 76-264

The Internal Revenue Service has reconsidered Rev. Rul. 57-615, 1957-2 C.B. 791, which relates to whether the weight of a hydraulic hoist that is mounted on a dump truck is to be included in determining the actual unloaded weight of the vehicle for purposes of the highway motor vehicle use tax imposed by section 4481 of the Internal Revenue Code of 1954.

Rev. Rul. 57-615 holds that since the hydraulic hoist, in addition to being used for unloading the cargo, anchors the dump body to the chassis, it is a part of the body and the weight of the hoist is to be included in determining the actual unloaded weight of the vehicle for purposes of the highway motor vehicle use tax.

Section 4481 of the Code imposes a tax on the use of any highway motor vehicle which has a taxable gross weight of more than 26,000 pounds.

As defined in section 4482(b) of the Code, the term "taxable gross weight" means the sum of (1) the actual unloaded weight of the highway motor vehicle fully equipped for service, and the semitrailers and trailers (fully equipped for service) customarily used in connection with highway motor vehicles of the same type as such highway motor vehicle, and (2) the weight of the maximum load customarily carried on highway motor vehicles of the same type, and on the trailers and semitrailers.

In the case of trucks and truck-tractors, section 41.4482(b)-1(b) of the Highway Motor Vehicle Use Tax Regulations defines the term "fully equipped for service" as including the body; all accessories; all equipment attached to or carried on the truck or truck-tractor for use in connection with the movement of the vehicle by means of its own motor or for use in the maintenance of the vehicle; and a full complement of lubricants, fuel, and water. However, the regulation also provides that the term does not include driver, any equipment (not including body) attached to or carried on the vehicle for use in handling, protecting, or preserving cargo; or any special equipment (such as an air compressor, crane, specialized oilfield machinery, etc.) mounted on the vehicle for use on construction jobs, in oilfield operations, etc.

Equipment of the type that would not be on a vehicle but for its use in loading, unloading, protecting, or preserving cargo is not to be included in determining actual unloaded weight merely because it performs some incidental function that in the absence of such equipment could be performed by another part of the vehicle or by the addition of minor equipment. See Rev. Rul. 76-263, page 361, this Bulletin, which holds that a hydraulic system and gears that serve to operate various panels and to raise and lower the tailgate to permit unloading of a rear loading packer-type refuse collection truck and also serve to lock the panels into place when the vehicle is in transit are not to be included in computing the actual unloaded weight of the vehicle. Such hydraulic system and gears are designed primarily to operate in connection with a loading and unloading function and only incidentally

serve to lock the various panels into place when the vehicle is in transit, which incidental function could be performed in the absence of the hydraulic system and gears by the addition of a few hinges and bolts. Similarly, the anchoring function of the hydraulic hoist in Rev. Rul. 57-615 is incidental to its unloading function. Furthermore, the anchoring function could be performed by the addition of a few bolts.

Since the hydraulic hoist would not be attached to the vehicle except for its use in unloading cargo and since the anchoring function is incidental and could be performed by the addition of minor items, the Service now concludes that a hydraulic hoist that is mounted on a dump truck is not to be included in computing the actual unloaded weight of the vehicle for purposes of the highway motor vehicle use tax.

For application of the manufacturers excise tax imposed by section 4061 (a) (1) of the Code to the sale of dump truck bodies complete with hoists, see Rev. Rul. 69-195, 1969-1 C.B. 276.

Rev. Rul. 57-615 is revoked.

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26 CFR 41.4482(b)-1: Definition of taxable gross weight.
(Also Section 4481; 41.4481-1.)

Highway use tax; public utility trucks. A utility truck, used by a public utility firm in the maintenance and installation of poles, lines, pipe conduits, etc., equipped with a pintle hook or coupling device for pulling a lightweight trailer is a single-unit vehicle but a similar vehicle, equipped with a pintle hook or coupling device suitable for towing a trailer with two or more axles or a one-axled trailer with a gross vehicle weight of 6,000 pounds or more, is a truck-trailer combination for purposes of the highway use tax; Rev. Rul. 57-547 modified.

Rev. Rul. 76-294 [1]

The Internal Revenue Service has been asked whether the conclusion set forth in Rev. Rul. 57-547, 1957-2 C.B. 789, with respect to the classification of certain utility trucks for purposes of the highway use tax imposed by section 4481(a) of the Internal Revenue Code of 1954, applies with respect to the utility trucks described below.

Rev. Rul. 57-547 is concerned with the classification for highway use tax purposes, of a utility truck of the type designed for the transportation of personnel, tools, and equipment. The vehicle is used by public utility companies in the maintenance and installation of poles, lines, pipe conduits, etc., and it is equipped with a pintle hook or similar coupling device for pulling a pipe or pole dolly, tool or equipment trailer, or other similar "lightweight" trailer. Under the Revenue Ruling, the vehicle is classified as a "single unit" for purposes of determining its taxable gross weight as provided in the use tax schedule set forth in the regulations.

As indicated above, in addition to transporting tools and equipment, the vehicle described in Rev. Rul. 57-547 is also designed to transport personnel; that is, accommodations are built into the body of the truck for transporting crew members who cannot be accommodated in the cab of the truck. The vehicles that are the subject of the request for advice in the instant case are also designed to transport tools and equipment in the same manner as the vehicle described in Rev. Rul. 57-547, however, they may be distinguished in two ways: (1) some of the trucks do not have crew compartments, and (2) all the trucks are equipped with pintle hooks or similar coupling devices that enable the vehicles to tow trailers of substantially greater weight than the pipe or pole dollies, or similar lightweight trailers referred to in Rev. Rul. 57-547.

[1] Also released as News Release IR-1636, dated July 9, 1976.

The specific question asked is whether the holding in Rev. Rul. 57-547 to the effect that the utility truck described therein is classifiable as a single unit within the meaning of section 41.4482(b)-1(d) of the Highway Motor Vehicle Use Tax Regulations, also applies to the vehicles in the instant case, or whether the latter vehicles should be classified as "truck-trailer combinations" under the regulations.

Section 4481(a) of the Code imposes a tax upon the use of any highway motor vehicle which (together with the semitrailers and trailers customarily used in connection with highway motor vehicles of the same type as such highway motor vehicle) has a taxable gross weight of more than 26,000 pounds.

Section 4482(b) of the Code provides as follows:

> Taxable Gross Weight.—For purposes of this subchapter, the term "taxable gross weight," when used with respect to any highway motor vehicle, means the sum of—
>
> (1) The actual unloaded weight of
>
> (A) such highway motor vehicle fully equipped for service, and
>
> (B) the semitrailers and trailers (fully equipped for service) customarily used in connection with highway motor vehicles of the same type as such highway motor vehicle, and
>
> (2) The weight of the maximum load customarily carried on highway motor vehicles of the same type as such highway motor vehicle and on the semitrailers and trailers referred to in paragraph (1)(B).
>
> Taxable gross weight shall be determined under regulations prescribed by the Secretary or his delegate (which regulations may include formulas or other methods for determining the taxable gross weight of vehicles by classes, specifications, or otherwise).

The schedule of taxable gross weights for determining the amount of the tax imposed under section 4481 of the Code is prescribed in section 41.4482(b)-1(d) of the regulations. For purposes of determining the taxable gross weight of a highway motor vehicle, the schedule includes the categories single units and truck-trailer combinations.

In the single unit category is any

truck designed for the transportation of property, and which is not equipped to tow a trailer or semitrailer of the type that forms a "combination" when coupled with a truck. In the truck-trailer combination category is any truck designed primarily for the transportation of property, and which is equipped for towing trailers or semitrailers of the type that form a combination when coupled with a truck, if trucks of the same type, when so equipped, are customarily used to tow such trailers or semitrailers. Trailers having two or more axles, and one-axled trailers with a gross vehicle weight (as defined in section 142.1-1 (d)(3) of the Temporary Excise Tax Regulations under the Revenue Act of 1971) of 6,000 pounds or more, are trailers of the type that form a combination when coupled with a truck.

Under the foregoing (A) a utility truck equipped with a pintle hook or similar coupling device suitable only for towing one-axled trailers with a gross vehicle weight of less than 6,000 pounds is not "equipped for use in combinations" and, therefore, is within the single unit category of the use tax schedule.

(B) A utility truck equipped with a pintle hook or similar coupling device suitable for towing a trailer with two or more axles, or a one-axled trailer with a gross vehicle weight of 6,000 pounds or more is a truck "equipped for use in combinations" and therefore is within the truck-trailer combination category of the use tax schedule.

It is immaterial whether in (A) and (B) above the trucks contain crew compartments.

The lightweight, special purpose trailers referred to in Rev. Rul. 57-547 are of the type described in (A) above that do not form a combination when coupled with a truck. Accordingly, the holding in Rev. Rul. 57-547 is not applicable to the utility trucks described in the instant case since they are of the type described in (B) above, and are classified as truck-trailer combinations within the meaning of section 41.4482 (b)-1(d) of the regulations.

Rev. Rul. 57-547 is modified to state the position on utility trucks equipped with pintle hooks or similar coupling devices to tow heavier trailers.

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26 CFR 41.4482(b)-1: Definition of taxable gross weight.
(Also Section 4481; 41.4481-1.)

Highway use tax; convertible units; fifth wheel or kingpin. A pickup truck equipped with a removable bar and fifth wheel attachment or a special folding kingpin in operating position is classified as a truck-trailer combination for highway use tax purposes; when not so equipped, it is classified as a truck. A truck-tractor equipped with a headramp to carry automobiles and a fifth wheel for towing semitrailers in transporting automobiles are classified as truck-tractors. Rev. Rul. 63-119 superseded.

Rev. Rul. 76-559

Advice has been requested concerning the classification of the vehicles described below for purposes of the tax imposed on the use of highway motor vehicles by section 4481(a) of the Internal Revenue Code of 1954.

Vehicle (1). This vehicle is a two-axle pickup truck with either a bar and fifth wheel attachment in the bed, or a special kingpin installed in the bed for coupling to an inverted fifth wheel mounted on a trailer. Vehicles of this type when so equipped customarily tow semitrailers. The fifth wheel attachment is placed across the bed over the rear axle and fitted into brackets mounted on either side of the bed. When the vehicle is not towing a semitrailer, the bar and fifth wheel can be removed from the brackets, or the kingpin, that is permanently hinged to a plate in the bed, can be folded flush with the floor.

Vehicle (2). This is a two-axled truck-tractor that is equipped with a fifth wheel mounted over the rear axle and is used for towing semitrailers that carry four automobiles. The vehicle is equipped with an automobile carrier body consisting of a superstructure designed to carry one automobile over the cab of the vehicle and one automobile behind the cab. Except for the superstructure that was added to carry the automobiles, the vehicle is essentially similar to a standard truck-tractor.

Section 4481(a) of the Code imposes a tax for each taxable period on the use of any highway motor vehicle which (together with the semitrailers and trailers customarily used in connection with highway motor vehicles of the same type as such highway motor vehicle) has a taxable gross weight of more than 26,000 pounds.

Section 41.4482(b)-1(d) of the Highway Motor Vehicle Use Tax Regulations sets forth a schedule of taxable gross weights for different categories of vehicles. The taxable gross weights are based on the number of axles and the actual unloaded weight of the truck or truck-tractor fully equipped for service, pursuant to paragraph (a) of that section. Among the categories shown in the schedule are single unit trucks; tractor-trailer combinations, under which the different types of truck-tractors are described; and truck-trailer combinations, under which the different types of trucks equipped for use in combination are described.

Rev. Rul. 57-259, 1957-1 C.B. 423, holds that any alteration of a vehicle subsequent to the vehicle's first taxable use in a given year will not affect the tax for the year in issue, even though the alteration, if considered, would change the vehicle's classification under the use tax schedule.

Rev. Rul. 63-119, 1963-1 C.B. 264, holds that certain highway motor vehicles equipped to carry two automobiles and also equipped with fifth wheels for towing semitrailers in transporting automobiles are truck-tractors for purposes of the use tax schedule. That Revenue Ruling states it is immaterial

that the vehicles are designed to carry some of the load as well as to pull some of the load.

Rev. Rul. 70-100, 1970-1 C.B. 242, holds that conversion of a two-axled truck-tractor to a three-axled truck-tractor, or vice versa, by addition or removal of a multi-purpose hitch after the first taxable use of the vehicle does not affect the highway use tax for the tax year in issue.

Rev. Rul. 71-304, 1971-2 C.B. 377, states that for purposes of the tax imposed by section 4481 of the Code, a vehicle falling within the tractor-trailer combination category of the use tax schedule is any motor vehicle designed primarily for towing semitrailers or trailers, and a vehicle falling within the truck-trailer combination category is any motor vehicle primarily designed for the transportation of property, and also equipped for use in towing semitrailers or trailers. That Revenue Ruling holds that a certain vehicle constructed by shortening a standard truck chassis and equipping it with a trailer hitch for towing mobile homes, and which has no provision for transporting personnel or property other than the operator and assistant, is primarily designed for towing trailers and falls within the tractor-trailer combination category.

Rev. Rul. 74-461, 1974-2 C.B. 377, holds that a two-axled truck equipped with a flat bed body is designed primarily for the transportation of property even though it is equipped with a special hitch mechanism for towing mobile homes and, therefore, is a truck-trailer combination for purposes of the use tax schedule.

Pursuant to Rev. Rul. 71-304, the classification of a vehicle for purposes of the combinations categories of the use tax schedule depends on its primary design for towing semitrailers or trailers, or transporting property. Thus, it is not necessary that a vehicle be designed to perform only one of those functions to the exclusion of the other in order to be "primarily" designed for towing semitrailers or trailers, or transporting property.

Although *Vehicle (1)*, the pickup truck, is equipped with a fifth wheel attachment or a special kingpin, the vehicle retains its primary character as a truck. Because of its truck characteristics, the modified vehicle is primarily designed for the transportation of property. Therefore, when equipped with the fifth wheel attachment or when the special kingpin is in operating position, the vehicle is customarily used with semitrailers of the type intended by the term combinations and is within the truck-trailer combination category of the use tax schedule.

When the pickup truck is not equipped with the fifth wheel attachment or the special kingpin is in the folded down position, the vehicle is not capable of use with semitrailers. In such case, the vehicle is a truck and is within the single unit category of the use tax schedule.

Since *Vehicle (2)* is a truck-tractor equipped with a fifth wheel, it is primarily designed for towing semitrailers even though it has some load carrying capacity. Therefore, this vehicle is within the tractor-trailer combination category of the use tax schedule.

Under Rev. Rul. 57-259 and Rev. Rul. 70-100, the determination of a vehicle's classification for highway use tax purposes must be made by reference to the vehicle's first taxable use in the current tax year. Thus, the tax on the use of *Vehicles (1)* and *(2)* is computed on the basis of the taxable gross weights of the vehicles determined from the use tax schedule at the time of their first taxable use in the current tax year. Any alteration of the vehicles subsequent to such first taxable use will not affect the tax due for that taxable period.

Rev. Rul. 63-119 is superseded since the conclusion therein is restated in this Revenue Ruling under current regulations.

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26 CFR 41.4482(b)-1: Definition of taxable gross weight.

Classification of certain beverage trucks for purposes of the highway use tax where they are equipped to tow trailers with beverage-type bodies. See Rev. Rul. 76-558, page 360.

Section 4483.—Exemptions

(Also Section 4481; 26 CFR 41.4481-1.)

Highway use tax exemption; American National Red Cross. The American National Red Cross comes within the term "United States" for purposes of the exemption from highway use tax authorized under section 4483(b) of the Code.

Rev. Rul. 76-510

Advice has been requested whether the use of highway motor vehicles by the American National Red Cross is exempt from the tax imposed on the use of certain highway motor vehicles by section 4481(a) of the Internal Revenue Code of 1954.

The American National Red Cross is a corporation organized and existing under an Act of Congress. It is exempt from Federal income tax as an organization described in section 501(c)(3) of the Code. One of its principal public services is a nationwide blood program making blood available at cost or less than cost to approximately three-quarters of the nation's Government and civilian hospitals. A large volume of blood is collected from volunteer donors through visits to collection sites by mobile collection facilities. These facilities are transported in and operated from highway type vehicles designated as bloodmobiles, mobile laboratories, and self-contained collection units.

Section 4481(a) of the Code imposes a tax on the use of any highway motor vehicle which (together with the semitrailers and trailers customarily used in connection with highway motor vehicles of the same type as such highway motor vehicle) has a taxable gross weight of more than 26,000 pounds.

Section 4483(b) of the Code provides that the Secretary of the Treasury may authorize exemption from the tax imposed by section 4481 as to the use by the United States of any particular highway motor vehicle or class of highway motor vehicles, if the Secretary determines that the imposition of such tax with respect to such use will cause substantial burden or expense which can be avoided by granting tax exemption and that full benefit of such exemption, if granted, will accrue to the United States.

Under the authority of section 4483 (b) of the Code, the Acting Secretary of the Treasury has authorized exemption from the tax imposed by section 4481 on the use by the United States of any highway motor vehicle on the public highways of the United States, whether or not such highway motor vehicle is owned by the United States. Acting Secretary's Authorization, 1956-2 C.B. 1369.

The specific question presented is whether the exemption from highway use tax provided the United States by the Assistant Secretary's Authorization applies to the use of vehicles by the American National Red Cross.

Section 4293 of the Code provides that the Secretary of the Treasury may authorize exemption from certain excise taxes, as to any particular article, or service or class of articles or services, to be purchased for the exclusive use of the United States, if the Secretary determines that the imposition of such taxes with respect to such articles or services, or class of articles or services will cause substantial burden or expense which can be avoided by granting tax exemption and that full benefit of such exemption, if granted, will accrue to the United States.

Under the authority of section 4293 of the Code, the Secretary of the Treasury has authorized exemption from the manufacturers excise taxes imposed by section 4071 on the sale of tires and inner tubes, if such articles are sold by any person on or in connection with, or with the sale of, any other article to the American National Red Cross for its exclusive use. Secretary's Authorization, 1963-1 C.B. 431.

Under the authority of section 4293 of the Code, the American National Red Cross was specifically exempted as an organization embraced by the term "United States" by the Secretary's Authorization. The language in section 4293 is similar to that of section 4483(b), which provides authorization for the exemption of the United States from the tax imposed by section 4481(a). Under section 4483(b), the United States has been specifically exempted from the tax imposed by section 4481(a) by the Acting Secretary's Authorization. Since the American National Red Cross has been determined to come within the term "United States" for purposes of section 4293, it follows that the American National Red Cross is included within the term United States for purposes of the exemption for the United States granted by the 1956 Acting Secretary's Authorization.

Accordingly, the use by the American National Red Cross of any highway motor vehicle on the public highways of the United States is not subject to the tax imposed by section 4481 of the Code.

Chapter 42.—Private Foundations

Section 4940.—Excise Tax Based on Investment Income

26 CFR 53.4940-1: Excise tax on net investment income.

Private foundations; interest in pre-1969 estate. Appreciated stock distributed to a private foundation in 1971, in satisfaction of a specific bequest and a percentage of the residuary estate of an individual who died in 1967, will be considered held by the foundation on December 31, 1969, and the basis of the stock for purposes of computing capital gain includible in net investment income will be the fair market value of the stock as of December 31, 1969 under section 4940(c)(4)(B) of the Code.

Rev. Rul. 76-424

Advice has been requested concerning the basis of shares of stock for purposes of determining net investment income of a private foundation under section 4940 of the Internal Revenue Code of 1954.

The will of an individual who died on April 22, 1967, provided for a specific bequest to a private foundation of 100 shares of stock in a particular corporation and for an additional distribution to the private foundation of 5 percent of the residuary estate.

On February 3, 1971, the executor of the estate transferred 300 shares of the corporate stock to the private foundation. Of this amount 100 shares of the stock were in satisfaction of the specific bequest and 200 shares were in satisfaction of the 5 percent residuary bequest.

The basis of the stock to the private foundation, determined under normal basis rules, is $6x$ dollars. Its fair market value on December 31, 1969, was $28x$ dollars.

Section 4940(a) of the Code imposes on a private foundation exempt under section 501(c)(3) an excise tax equal to 4 percent of its net investment income for the taxable year.

Net investment income is defined in section 4940(c)(1) of the Code as the amount by which the sum of the gross investment income (from dividends, interest, rents, and royalties) and the net capital gain exceeds the deductions allowed under section 4940(c)(3).

Section 4940(c)(4)(B) of the Code provides that for purposes of determining net capital gain includible in net investment income, the basis for determining gain in the case of property held on December 31, 1969, and continuously thereafter to the date of disposition shall be deemed to be not

less than the fair market value of such property on December 31, 1969.

Section 53.4940-1(f)(2)(i) of the Foundation Excise Tax Regulations provides that the basis for purposes of determining gain from the sale or other disposition of property shall be the greater of (a) the fair market value on December 31, 1969, (plus or minus all adjustments after that date and before the date of disposition under the rules of Part II of Subchapter 0 of Chapter 1) provided that the property was held by the private foundation on December 31, 1969, and continuously thereafter to the date of disposition, or (b) the basis as determined under the normal basis rules (but without regard to section 362(c)).

The purpose of the section 4940(c)(4)(B) and section 53.4940-1(f)(2)(i) rules regarding the basis of property for computing capital gain is to avoid taxing appreciation of property prior to the enactment of the taxing statute.

Accordingly, for purposes of section 4940(c)(4)(B) of the Code, the 300 shares of stock that were distributed to the private foundation in 1971 will be considered to have been held by the foundation on December 31, 1969, even though the stock was held by an estate on that date and even though, in the case of the residuary bequest, the property that ultimately passed to the foundation had not been identified on that date. Thus, if the foundation holds the stock continuously to the date of disposition, its basis for computing capital gain will be the December 31, 1969, value of 28x dollars, plus or minus any adjustments after that date and before the date of disposition.

This Ruling with respect to when property will be considered to have been held by a private foundation on December 31, 1969, reflects the purpose of section 4940(c)(4)(B) of the Code and is limited in scope and application to that section.

26 CFR 53.4940-1: Excise tax on net investment income.

Whether a Belgian private foundation is subject to the excise tax imposed by section 4948(a) of the Code on its investment income when (1) the United States-Belgium Income Tax Convention reduces the normal 30 percent withholding rate on such income to 15 percent and (2) the Friendship, Establishment, and Navigation Treaty with Belgium prohibits the United States from taxing Belgian companies at rates more burdensome than those imposed on third country nationals. See Rev. Rul. 76-330, page 488.

Section 4941.—Taxes On Self-Dealing

26 CFR 53.4941(d)-2: Specific acts of self-dealing.
(Also Section 4946; 53.4946-1.)

Private foundation; exchange of securities; self-dealing. An act of self-dealing will not result from the exchange of securities between a private foundation and a corporation that was previously a disqualified person by reason of the ownership of more than 35 percent of its total combined voting power by the former foundation manager, who resigned 5 years prior to the exchange, and who did not participate in planning the exchange offer during the period of disqualification.

Rev. Rul. 76-448

Advice has been requested whether, under the circumstances described below, the proposed exchange of securities between a private foundation and a corporation will constitute an act of "self-dealing" within the meaning of section 4941(d)(1)(A) of the Internal Revenue Code of 1954.

A private foundation that is the owner of certain shares of nonvoting stock of a particular corporation proposes to enter into a transaction with the corporation to exchange the nonvoting stock for certain other securities of the corporation. Pursuant to an offer made in 1976 to all owners of the nonvoting stock, the corporation has offered to purchase all of its outstanding nonvoting stock in exchange for cash and the corporation's debenture.

A former foundation manager of the foundation who resigned in 1970 owns more than 35 percent of the total combined voting power of the corporation. Prior to the foundation manager's resignation from the foundation, the corporation was a "disqualified person" within the meaning of section 4946(a)(1)(E) of the Code with respect to the foundation by virtue of the manager's ownership of more than 35 percent of its total combined voting power.

The status of the corporation as a disqualified person with respect to the foundation rested solely upon the ownership of more than 35 percent of its total combined voting power by the former foundation manager. The status of the former foundation manager as a disqualified person with respect to the foundation rested solely upon his capacity as a foundation manager. All of the aspects of the proposed exchange of securities occurred after the resignation of the foundation manager who was not connected in any way with the proposed exchange while serving in the capacity of foundation manager.

Section 4941(d)(1)(A) of the Code defines the term "self-dealing" as including any direct or indirect sale or exchange, or leasing, of property between a private foundation and a disqualified person.

Section 4946(a)(1)(B) of the Code defines the term "disqualified person" to include, with respect to a private foundation, a person who is a foundation manager.

Section 4946(a)(1)(E) of the Code defines the term "disqualified person" as including a corporation of which persons described in subparagraph (B) own more than 35 percent of the total combined voting power.

The corporation's status as a disqualified person was attributable only to the ownership of more than 35 percent of its voting power by another

disqualified person, the foundation manager. Therefore, the resignation and separation from the foundation of the foundation manager terminated the status of the corporation as a disqualified person with respect to the foundation.

Accordingly, the exchange of securities between the foundation and the corporation, under the circumstances described above, will not constitute an act of self-dealing within the meaning of section 4941(d)(1)(A) of the Code.

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26 CFR 53.4941(d)-3: Exceptions to self-dealing.

Private foundation self-dealing; use of private road by disqualified person. The use of a private foundation museum's private road for access to the adjacent headquarters and manufacturing plant of a corporation (a disqualified person) during the same hours the road is used by the general public as a thoroughfare connecting two public streets is not an act of self-dealing.

Rev. Rul. 76-459

Advice has been requested whether, under the circumstances described below, the use of a private foundation's private road by a disqualified person constitutes an act of self-dealing within the meaning of section 4941(d)(1)(C) of the Internal Revenue Code of 1954.

The private foundation is exempt from Federal income tax under section 501(c)(3) of the Code, and is a private foundation within the meaning of section 509(a). Its primary activity is the operation of a museum open to the general public.

Adjacent to the private foundation's museum property is the headquarters and manufacturing plant of a corporation that is a disqualified person, within the meaning of section 4946(a) of the Code, with respect to the foundation. Separating the foundation's property and the property of the disqualified person is a private road owned by the foundation. This road serves as the entrance to the foundation's museum, and is open at all times that the museum is open. Access to the road is permitted only through gates at either end controlled exclusively by the foundation. During the period of time that the road is open, the general public is permitted to use the road for access to the museum, or as a thoroughfare connecting two public streets that intersect it at either end.

In addition to providing access to the museum, and connecting the two public streets, the road is intersected by an entrance drive to the property of the disqualified person. The corporation's employees and members of the public doing business with the corporation may use the road whenever the gates are open.

During the hours that the road is open to the public, it is in fact in regular and continuous use as if it were an integral part of the municipal street system. Residents and visitors to the community use the road as a thoroughfare between the two public streets that intersect the road at either end. There is presently no convenient substitute for traveling between the two public streets.

In order to induce the foundation to continue its practice of allowing use of the road by the corporation and the general public, the corporation has entered into an agreement with the foundation to keep the road in good repair at the expense of the corporation. This agreement provides that the use of the road by the corporation shall be subject to the same restrictions or conditions that the foundation imposes on such use by the general public.

Section 4941(a) of the Code imposes a tax on any act of "self-dealing" between a disqualified person and a private foundation.

Section 4941(d)(1)(C) of the Code defines the term "self-dealing" to include the furnishing of goods, services, or facilities between a private foundation and a disqualified person.

Section 4941(d)(2)(D) of the Code provides that the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public. Section 53.4941(d)-3(b)(2) of the Foundation Excise Tax Regulations provides that this exception does not apply, however, unless there are a substantial number of persons other than disqualified persons who actually use the goods, services, or facilities.

Section 53.4941(d)-3(b)(1) of the regulations provides that, after May 16, 1973, the exception set forth in section 4941(d)(2)(D) of the Code shall only apply if the goods, services, or facilities are functionally related, within the meaning of section 4942(j)(5), to the exercise or performance by a private foundation of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(c)(3).

Rev. Rul. 76-10, 1976-1 C.B. 355, holds that the use of a private foundation's meeting room by a disqualified person is not an act of self-dealing within the meaning of section 4941(d)(1)(C) of the Code. The room is made available to the disqualified person on the same basis that it is made available to the general public, and is functionally related within the meaning of section 4942(j)(5) to the performance of an exempt purpose of the foundation.

Generally, by permitting a disqualified person to use its private road, a private foundation would be engaging in an act of self-dealing. However, in this situation, the road is made available to the disqualified person on a basis that is no more favorable than the basis on which it is made available to the general public. In addition, a substantial number of persons other than disqualified persons actually use the road. The fact that the disqualified

person has agreed to maintain the road does not entitle it to any special privileges with respect to the use of the road not otherwise available to the general public. Further, the use of the road as an entrance to the foundation's museum is functionally related within the meaning of section 4942(j)(5) of the Code to the foundation's exempt purpose of operating a museum for the benefit of the general public.

Accordingly, the use of the private foundation's private road by the disqualified person does not constitute an act of self-dealing within the meaning of section 4941(d)(1)(C) of the Code.

Section 4942.—Taxes on Failure to Distribute Income

26 CFR 53.4942(b)-1:Operating foundations.

Procedures for issuing determination and ruling letters on operating foundation status under section 4942(j)(3) of the Code. See Rev. Proc. 76-34, page 656.

Section 4945.—Taxes on Taxable Expenditures

26 CFR 53.4945-4: Grants to individuals.

Private foundation; scholarship grants; taxable expenditures. Scholarship grants made to individuals by a private foundation on the basis of academic standing, financial need, personal history, the cost of the programs of study to be pursued, and the likelihood that the recipients will be able to finance the balance of the cost of their education, are not taxable expenditures within the meaning of section 4945(d)(3) of the Code.

Rev. Rul. 76-340

Advice has been requested whether grants to individuals made by a private foundation in the manner described below are taxable expenditures within the meaning of section 4945(d)(3) of the Internal Revenue Code of 1954.

The private foundation is a testamentary trust recognized as exempt from Federal income tax under section 501(c)(3) of the Code. It was created to provide college scholarship grants to students attending a high school in a certain locality within a city. The grants constitute scholarships which are excludable from the gross income of the recipients under section 117(a), and which are to be used for study at educational institutions described in section 151(e)(4).

A selection committee, made up of three high school principals and the director of the city's recreation center in that part of the city, selects the recipients based on information submitted on an application form and gained from personal interviews. Criteria used in selecting a recipient include academic standing, financial need, personal history, the cost of the program of study to be pursued by the applicant, and sources of income available to the applicant other than the trust's scholarship grant. The committee gives preference to those applicants who are likely to be able to finance the balance of the cost of their education.

Section 4945 of the Code imposes a tax on each taxable expenditure made by a private foundation.

Section 4945(d)(3) of the Code defines the term "taxable expenditure" to include any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfies the requirements of section 4945(g).

Section 4945(g) of the Code provides, in part, that grants to an individual for travel, study, or other similar purposes will not be considered as "taxable expenditures" if they are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary or his delegate, and if it is demonstrated that the grant constitutes a scholarship which is subject to the provisions of section 117(a) and is to be used for study at an educational institution described in section 151(e)(4).

Section 53.4945-4(b) of the Foundation Excise Tax Regulations provides, in part, that in order for a foundation to establish that its grants to individuals are made on an objective and nondiscriminatory basis, the grants must be awarded in accordance with a program which, if it were a substantial part of the foundation's activities, would be consistent with the existence of the foundation's exempt status under section 501(c)(3) of the Code and would require that the criteria used in selecting grant recipients from the potential grantees be related to the purpose of the grant.

A trust for educational purposes is charitable although the persons to be educated are not limited to the poor. The fact that recipients of scholarships are selected on the basis of scholastic ability without regard to financial need does not preclude exemption under section 501(c)(3) of the Code. See Rev. Rul. 69-257, 1969-1 C.B. 151.

The committee selects recipients on the basis of scholastic ability as well as other criteria which are related to the educational purposes of the trust. One such criterion is the cost of the program the applicant proposes to pursue, and whether the applicant is likely to be able to finance it with the foundation's assistance. By including such a factor in its consideration, the committee attempts to assure that the foundation's grants are likely to see the recipient through to the completion of an educational program.

By operating in the manner described above, the foundation has demonstrated that its scholarship grants are made on an objective and nondiscriminatory basis within the meaning of section 4945(g) of the Code. It has also demonstrated that its grants constitute scholarships which are subject to the provisions of section 117(a) and are to be used for study at an educational institution described in section 151(e)(4). Accordingly, the founda-

tion's scholarship grants are not "taxable expenditures" within the meaning of section 4945(d)(3).

Even though a private foundation considers its grant making program within the scope of this Revenue Ruling, it must request advance approval of its procedures in accordance with section 53.4945-4(d) of the regulations.

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26 CFR 53.4945-4: Grants to individuals.

Private foundation taxable expenditures; craft competition. An unconditional and unrestricted grant by a private foundation to the winner of a competition conducted among students attending schools specializing in teaching a special craft is not a taxable expenditure within the meaning of section 4945(d) of the Code; Rev. Rul. 75-393 modified.

Rev. Rul. 76-460

Advice has been requested whether, under the circumstances described below, grants awarded by a private foundation to individuals are taxable expenditures within the meaning of section 4945(d)(3) or 4945(d)(5) of the Internal Revenue Code of 1954.

The foundation is a trust created for charitable and educational purposes. As part of its educational program, it sponsors an annual competition among students attending schools specializing in teaching a particular craft. The purpose of this competition is to raise the quality standards in the craft courses of the schools by giving students a professional framework in which to create new products, which will be evaluated by top professionals in the field.

Each school that signifies an intent to enter students in the competition designates a member of its faculty as the official representative of the school. Those students desiring to compete are required to notify the designated faculty representative who then prepares and submits the necessary entry forms.

The faculty representative, together with a committee made up of other members of the faculty, selects the best entries from that particular school. These entries are forwarded to the Competition Committee of the foundation. The entries from all participating schools are then forwarded to a panel of professional people who are independent of the foundation. This panel evaluates the entries. Pursuant to this evaluation, the foundation awards grants to the students whose products the Competition Committee judges to be the best. The students retain the products submitted and the foundation exercises no rights over the products. There is no requirement that the selected individuals perform any further activity, such as prepare a special report, attend school, etc. There is also no restriction as to the use to which the individuals may put the grants.

Section 4945 of the Code imposes a tax on each taxable expenditure made by a private foundation.

Section 4945(d)(3) of the Code provides that the term "taxable expenditure" includes any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfies the requirements of section 4945(g).

Section 53.4945-4(a)(3)(i) of the Foundation Excise Tax Regulations provides that a grant to an individual for purposes other than those described in section 4945(d)(3) of the Code is not a taxable expenditure within the meaning of that section even if the requirements of section 4945(g) are not met.

The grants made to the individuals under the program described above are granted in recognition of past achievements in the craft course. They are not intended to finance any future activities of an individual grantee. No conditions are imposed on the manner in which the awards may be expended by the recipients.

Accordingly, the grants in question are made for purposes other than those stated in section 4945(d)(3) of the Code and are not taxable expenditures within the meaning of that section.

However, even if a grant to an individual is for a purpose not described in section 4945(d)(3) of the Code, it may still be a "taxable expenditure" if it does not meet the requirements of section 4945(d)(5).

Section 4945(d)(5) of the Code treats an expenditure for "any purpose other than one specified in section 170(c)(2)(B)" as a taxable expenditure. Section 170(c)(2)(B) refers to "religious, charitable, scientific, literary, or educational purposes or . . . prevention of cruelty to children or animals."

The grants in question are made for educational purposes within the meaning of section 170(c)(2)(B) of the Code and, thus, are not taxable expenditures within the meaning of section 4945(d)(5).

See also Rev. Rul. 75-393, 1975-2 C.B. 451, which holds that an award by a private foundation to a person who has written the best work of literary criticism during the preceding year is not a taxable expenditure within the meaning of section 4945(d)(3) of the Code. However, to the extent Rev. Rul. 75-393 can be read to imply that a grant falling outside the scope of section 4945(d)(3) need not comply with the requirements of section 4945(d)(5), it is modified.

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26 CFR 53.4945-4: Grants to individuals.

Private foundation taxable expenditures; science award. An award by a private foundation to a high school senior whose exhibit receives top honors in a local science fair and is conditioned on the student's agreeing to use the award for educational activities may be a taxable expenditure under sections 4945(d)(3) and 4945(g) of the

Code; Rev. Rul. 75-393 distinguished.

Rev. Rul. 76-461

Advice has been requested whether, under the circumstances described below, grants to individuals by a private foundation are subject to the provisions of section 4945(d)(3) of the Internal Revenue Code of 1954.

Each year the foundation awards a cash prize to the high school senior who wins top honors in a local science fair. Each high school in the local community participates in the competition by entering the exhibits of its students and by permitting its science faculty to assist in judging the exhibits.

Prior to awarding the cash prize to the students whose exhibit receives top honors, the foundation requires the student to agree to use the award for his or her education, usually to pursue a college degree.

Section 4945 of the Code imposes a tax on each taxable expenditure made by a private foundation.

Section 4945(d)(3) of the Code provides that the term "taxable expenditure" includes any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purpose by such individual, unless such grant satisfies the requirements of section 4945(g).

Section 53.4945-4(a)(3)(i) of the Foundation Excise Tax Regulations provides that a grant to an individual for purposes other than those described in section 4945(d)(3) of the Code is not a taxable expenditure within the meaning of that section, even if the requirements of section 4945(g) are not met. However, as Rev. Rul. 76-460, page 14, indicates, a grant to an individual for purposes other than those described in section 4945(d)(3) may constitute a taxable expenditure under section 4945(d)(5).

Rev. Rul. 75-393, 1975-2 C.B. 451, holds that an award by a private foundation to the person who has written the best work of literary criticism during the preceding year is not a taxable expenditure within the meaning of section 4945(d)(3) of the Code. These awards are not intended to finance any future activities of an individual grantee, and no conditions are imposed on the manner in which the awards may be expended by the recipients.

In the instant case, the award made to the individual who wins the local science fair is granted in recognition of a past achievement, as is the case in Rev. Rul. 75-393. However, unlike the situation described in that Revenue Ruling, the award here is intended to finance future educational activities of the grantee, and conditions are imposed on the manner in which the award may be expended by the recipient.

Accordingly, the awards in the instant case are subject to the provisions of section 4945(d)(3) of the Code and will constitute taxable expenditures unless the foundation's grant-making procedures satisfy the requirements of section 4945(g).

Rev. Rul. 75-393 is distinguished.

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26 CFR 53.4945-4: Grants to individuals.

Guidelines providing rules for determining whether educational grants qualify as scholarships or fellowship grants. See Rev. Proc. 76-47, page 670.

Section 4946.—Definitions and Special Rules

26 CFR 53.4946-1: Definitions and special rules.

Status of a corporation that was formerly a "disqualified person" with respect to a private foundation. See Rev. Rul. 76-448, page 368.

Section 4947.—Application of Taxes to Certain Nonexempt Trusts

26 CFR 53.4947-1: Application of tax.

T.D. 7431

TITLE 26, INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 53.—FOUNDATION EXCISE TAXES

Application of taxes to certain nonexempt trusts

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C., 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

By a notice of proposed rule making appearing in the Federal Register for Thursday, March 18, 1971 (36 F.R. 25015), amendments to the Foundation Excise Tax Regulations (26 CFR Part 53) were proposed in order to provide rules for the application of such taxes to certain nonexempt trusts under section 4947 of the Internal Revenue Code of 1954. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, certain changes were made, and the proposed amendments of the regulations, subject to the changes, are adopted by this document.

Section 4947 generally subjects nonexempt charitable trusts to many of the requirements and restrictions imposed on private foundations in order to prevent taxpayers from avoiding these restrictions by the use of nonexempt trusts instead of private foundations. Thus, many nonexempt charitable trusts are subject to those provisions relating to self-dealing, retention of excess business holdings, and the making of speculative investments or taxable expenditures, but not the current income payout requirement if the trust is a split-interest trust (one in which not all the interests are charitable). However, the stock ownership and speculative investment requirements do not apply to split-interest trusts (a) in cases where charity is the only income beneficiary (and has no remainder interest) and the beneficial

nterest of charity in the trust is not nore than 60 percent of the value of he trust property and also (b) in :ases where the only interest of charity n the trust is as a remainderman (and here are no noncharitable remainder nterests). In the latter case, the stock ›wnership and speculative investment equirements become applicable at the ime the charitable remainder interest :omes into possession.

The final regulations expand upon he proposed regulations by providing ıdditional rules for determining the :inds of trusts that are subject to section 4947, when its provisions become .pplicable to trusts and the extent to vhich its provisions make other pro-isions of the Internal Revenue Code .pplicable to trusts.

ldoption of amendments to the egulations

In consideration of the foregoing, he Foundation Excise Tax Regula-ions (26 CFR Part 53) are amended s follows:

Immediately after § 53.4946-1, in-ert the following sections:

UBPART H. APPLICATION TO CERTAIN NONEXEMPT TRUSTS.

53.4947 Statutory provisions; application of taxes to certain nonexempt trusts.

Sec. 4947. *Application of taxes to certain onexempt trusts*—(a) *Application of tax* -(1) *Charitable trusts.* For purposes of art II of subchapter F of chapter 1 (other ıan section 508(a), (b), and (c) and for ırposes of this chapter, a trust which is)t exempt from taxation under section)1(a), all of the unexpired interests in hich are devoted to one or more of the ırposes described in section 170(c)(2) 3), and for which a deduction was al-wed under section 170, 545(b)(2), 556)(2), 642(c), 2055, 2106(a)(2), or 2522 r the corresponding provisions of prior w), shall be treated as an organization scribed in section 501(c)(3). For pur-ses of section 509(a)(3)(A), such a ıst shall be treated as if organized on the y on which it first becomes subject to this ragraph.

(2) *Split-interest trusts.* In the case of a ıst which is not exempt from tax under :tion 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, section 507 (relating to termination of private foundation status), section 508(e) (relating to governing instruments) to the extent applicable to a trust described in this paragraph, section 4941 (relating to taxes on self-dealing), section 4943 (relating to taxes on excess business holdings) except as provided in subsection (b)(3), section 4944 (relating to investments which jeopardize charitable purpose) except as provided in subsection (b)(3), and section 4945 (relating to taxes on taxable expenditures) shall apply as if such trust were a private foundation. This paragraph shall not apply with respect to—

(A) Any amounts payable under the terms of such trust to income beneficiaries, unless a deduction was allowed under section 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B),

(B) Any amounts in trust other than amounts for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such other amounts are segregated from amounts for which no deduction was allowable, or

(C) Any amounts transferred in trust before May 27, 1969.

(3) *Segregated amounts.* For purposes of paragraph (2)(B), a trust with respect to which amounts are segregated shall separately account for the various income, deduction, and other items properly attributable to each of such segregated amounts.

(b) *Special rules*—(1) *Regulations.* The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section.

(2) *Limit to segregated amounts.* If any amounts in the trust are segregated within the meaning of subsection (a)(2)(B) of this section, the value of the net assets for purposes of subsections (c)(2) and (g) of section 507 shall be limited to such segregated amounts.

(3) *Sections 4943 and 4944.* Sections 4943 and 4944 shall not apply to a trust which is described in subsection (a)(2) if—

(A) All the income interest (and none of the remainder interest) of such trust is devoted solely to one or more of the purposes described in section 170(c)(2)(B), and all amounts in such trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 have an aggregate value not more than 60 percent of the aggregate fair market value of all amounts in such trust[s], or

(B) A deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 for amounts payable under the terms of such trust to every remainder beneficiary but not to any income beneficiary.

[Sec. 4947, as added by sec. 101(b) Tax Reform Act 1969 (83 Stat. 517) [Pub. L. 91-172, 1969-3 C.B. 10]]

§ 53.4947-1 Application of tax.

(a) *In general.* Section 4947 subjects trusts which are not exempt from taxation under section 501(a), all or part of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which have amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 to the same requirements and restrictions as are imposed on private foundations. The basic purpose of section 4947 is to prevent these trusts from being used to avoid the requirements and restrictions applicable to private foundations. For purposes of this section, a trust shall be presumed (in the absence of proof to the contrary) to have amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 if a deduction would have been allowable under one of these sections. Also for purposes of this section and § 53.4947-2, the term "purposes described in section 170(c)(2)(B)" shall be treated as including purposes described in section 170(c)(1).

(b) *Charitable trusts*—(1) *General rule.* (i) For purposes of this section and § 53.4947-2, a "charitable trust", within the meaning of section 4947(a)(1), is a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2) or 2522 (or the corresponding provisions of prior law). A trust is one for which a deduction was allowed under section 642(c), within the meaning of section 4947(a)(1), once a deduction is allowed under section 642(c) to the trust for any

amount paid or permanently set aside. (See section 642(c) and § 1.642-4 for the limitation on such deduction in certain cases.) A charitable trust (as defined in this paragraph) shall be treated as an organization described in section 501(c)(3) and, if it is determined under section 509 that the trust is a private foundation, then Part II of subchapter F of chapter 1 of the Code (other than section 508(a), (b) and (c)) and chapter 42 shall apply to the trust. However, the charitable trust is not treated as an organization described in section 501(c)(3) for purposes of exemption from taxation under section 501(a). Thus, the trust is subject to the excise tax on its investment income under section 4940(b) rather than the tax imposed by section 4940(a). For purposes of satisfying the organizational test described in § 1.501(c)(3)-1(b) when a charitable trust seeks an exemption from taxation under section 501(a), a charitable trust (as defined in this paragraph) shall be considered organized on the day it first becomes subject to section 4947(a)(1). However, for purposes of the special and transitional rules in sections 4940(c)(4)(B), 4942(f)(4), 4943(c)(4)(A)(i) and (B) and section 101(l)(2)(A), (B), (C), and (D), and (l)(3) of the Tax Reform Act of 1969 (Pub. L. 91-172, 1969-3 C.B. 10), a charitable trust (as defined in this paragraph) shall be considered organized on the first day it has amounts in trust for which a deduction was allowed (within the meaning of paragraph (a) of this section) under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522. Thus, under this rule, a trust may be treated as a private foundation in existence on a date governing one of the applicable special and transitional rules even though the trust did not otherwise become subject to the provisions of chapter 42 until a later date.

(ii) The provisions of paragraph (b)(1) of this section may be illustrated by the following examples:

Example (1). On January 30, 1970, X creates an *inter vivos* trust under which M receives 50 percent and N receives 50 percent of the trust's income for 10 years, and upon the termination of which, at the end of the 10-year period, the corpus is to be distributed to O. M, N and O are all organizations described in section 501(c)(3), and X is allowed a deduction under section 170 for the value of all interests placed in trust. The trustees of the trust do not give notice to the Internal Revenue Service under the provisions of section 508(a), and the trust will therefore not be exempt from taxation under section 501(a). The trust is a charitable trust within the meaning of section 4947(a)(1) from the date of its creation.

Example 2. On March 1, 1971, Y creates a charitable remainder annuity trust described in section 664(d)(1) under which Z, Y's son, receives $10,000 per year for life, remainder to be held in trust for P, an organization described in section 501(c)(3). Y is allowed a deduction under section 170 for the present value of the remainder interest to P. During Z's lifetime, the trust is a split-interest trust described in section 4947(a)(2) and paragraph (c) of this section. Upon the death of Z, all unexpired interests (consisting of P's remainder interest) will be devoted to section 170(c)(2)(B) purposes. Except as provided in §53.4947-1(b)(2)(iv) (relating to a reasonable period of settlement) the trust will be treated as a charitable trust within the meaning of section 4947(a)(1) from the date of the death of Z unless the trustees of the trust apply for recognition of section 501(c)(3) status under the provisions of section 508(a).

(2) *Scope of application of section 4947(a)(1).*—(i) *In general.* Subject to paragraph (b)(2)(ii) through (vii) of this section, section 4947(a)(1) applies to nonexempt trusts in which all unexpired interests are charitable. For purposes of this section, the term "charitable" when used to describe an interest or beneficiary refers to the purposes described in section 170(c)(2)(B). An estate from which the executor or administrator is required to distribute all of the net assets in trust to such beneficiaries will not be considered a charitable trust under section 4947(a)(1) during the period of estate administration or settlement, except as provided in paragraph (b)(2)(ii) of this section. A charitable trust created by will shall be considered a charitable trust under section 4947(a)(1) as of the date of death of the decedent-grantor, except as provided in paragraph (b)(2)(v) of this section (relating to trusts which wind up). For the circumstances under which segregated amounts are treated as charitable trusts, see § 53.4947-1(c)(3)(iii).

(ii) *Estates.* (A) When an estate from which the executor or administrator is required to distribute all of the net assets in trust for charitable beneficiaries, or free of trust to such beneficiaries, is considered terminated for Federal income tax purposes under § 1.641(b)-3(a), then the estate will be treated as a charitable trust under section 4947(a)(1) between the date on which the estate is considered terminated under § 1.641(b)-3(a) and the date final distribution of all of the net assets is made to or for the benefit of the charitable beneficiaries. This (ii) does not affect the determination of the tax liability under subtitle A of the beneficiaries of the estates.

(B) The provisions of this (ii) may be illustrated by the following example:

Example. X bequeaths his entire estate, including 100 percent of the stock of a wholly-owned corporation, to M, an organization described in section 501(c)(3), under a will which gives his executor authority to hold the stock and manage the corporaion for a period of up to 10 years for the benefit of M prior to its ultimate disposition. A deduction for the charitable bequest was allowed to X's estate under section 2055. The executor is vested with a full range of powers, including the power of sale. Upon the death of X, his executor distributes X's assets to M except for the stock of the corporation, which he holds for 5 years prior to its disposition. The continued holding of the stock of the corporation by the executor after the expiration of a reasonable time for performance of all the ordinary duties of administration causes the estate to be considered terminated for Federal income tax purposes pursuant to § 1.641(b)-3(a) and thereby subjects it to the provisions of section 4947(a)(1) from the date of such termination to the date of final disposition of the stock of the corporation.

(iii) *Certain split-interest trusts which wind up.* A split-interest trust

(as defined in paragraph (c) of this section) in which all of the unexpired interests are charitable remainder interests and in which the charitable beneficiaries have become entitled to distributions of corpus in trust or free of trust shall continue to be treated as a split-interest trust under section 4947(a)(2) until the date on which final distribution of all the net assets is made. However, if after the expiration of any intervening interests the trust is considered terminated for Federal income tax purposes under § 1.641(b)-3(b), then the trust will be treated as a charitable trust under section 4947(a)(1), rather than a split-interest trust under section 4947(a)(2), between the date on which the trust is considered terminated under § 1.641(b)-3(b) and the date on which such final distribution of all of the net assets is made to or for the benefit of the charitable remainder beneficiaries. This (iii) does not affect the determination of the tax liability under subtitle A of the beneficiaries of the trusts.

(iv) *Split-interest trusts which become charitable trusts.* (A) A split-interest trust (as defined in paragraph (c) of this section) in which all of the unexpired interests are charitable remainder interests and in which some or all of the charitable beneficiaries are not entitled to distributions of corpus within the meaning of paragraph (b)(2)(iii) of this section shall continue to be treated as a split-interest trust under section 4947(a)(2) rather than a charitable trust under section 4947(a)(1) for a reasonable period of settlement after the expiration of the noncharitable interest. Thus, a split-interest trust which under its terms is to continue to hold assets for charitable beneficiaries after the expiration of the noncharitable interest rather than distributing them as in paragraph (b)(2)(iii) of this section is given a reasonable period of settlement before being treated as a charitable trust. For purposes of this paragraph, the term "reasonable period of settlement" means that period reasonably required (or if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of the rights of the subsequent beneficiaries.

(B) This (iv) may be illustrated by the following example:

Example. On January 15, 1971, A creates a charitable remainder annuity trust described in section 664(d)(1) under which the trustees are required to distribute $10,000 a year to B, A's wife, for life, remainder to be held in trust for the use of M, an organization described in section 501(c)(3). A is allowed a deduction under section 170 for the amount of the charitable interest, and the trust is, therefore, treated as a split-interest trust under section 4947(a)(2) from the date of its creation. B dies on February 10, 1975. On April 15, 1975, the trustees complete performance of the ordinary duties of administration necessary for the settlement of the trust brought about by the death of B. These duties include, for example, an accounting for and payment to the estate of B of amounts accrued by B while alive during 1975. However, the trustees do not distribute the corpus to M by April 15, 1975. The trust shall continue to be treated as a split-interest trust under section 4947(a)(2) until April 15, 1975. After April 15, 1975, the trust shall be treated as a charitable trust under section 4947(a)(1).

(v) *Certain revocable and testamentary trusts which wind up.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust for or free of trust to charitable beneficiaries is not considered a charitable trust under section 4947(a)(1) for a reasonable period of settlement (within the meaning of paragraph (b)(2)(iv) of this section) after becoming irrevocable. After that period the trust is considered a charitable trust under section 4947)(a)(1).

(vi) *Revocable trusts which become charitable trusts.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor in which all of the unexpired interests are charitable and under the terms of the governing instrument of which the trustee is required to hold some or all of the net assets in trust after becoming irrevocable solely for charitable beneficiaries is not considered a trust under section 4947(a)(1) for a reasonable period of settlement (within the meaning of paragraph (b)(2)(iv) of this section) after becoming irrevocable except that section 4941 may apply if the requirements of § 53.4941(d)-1(b)(3) are not met. After that period, the trust is considered a charitable trust under section 4947(a)(1).

(vii) *Trust devoted to 170(c) purposes.* (A) A trust all of the unexpired interests in which are devoted to section 170(c)(3) or (5) purposes together with section 170(c)(2)(B) purposes shall be considered a charitable trust except that payments under the terms of the governing instrument to an organization described in section 170(c)(3) or (5) shall not be considered a violation of section 4945(d)(5) or any other provisions of chapter 42 and shall be considered qualifying distributions under section 4942.

(B) *Example.* The application of paragraph (b)(2)(vii) of this section may be illustrated by the following example:

Example. On January 30, 1970, H creates an *inter vivos* trust under the terms of the governing instrument of which M, an organization described in section 170(c)(3), and N, an organization described in section 501(c)(3), are each to receive 50 percent of the income for a period of 10 years. At the end of the 10 year period, the corpus is to be distributed to O, an organization also described in section 501(c)(3). H is allowed a deduction under section 170 for the value of all interests placed in trust. The payments to M do not constitute a violation of section 4945(d)(5) or any other provision of chapter 42 and constitute qualifying distributions under section 4942. However, except as provided in the previous sentence, the trust shall be considered a charitable trust.

(3) *Charitable trusts described in section 509(a)(3).* For purposes of section 509(a)(3)(A), a charitable

trust shall be treated as if organized on the day on which it first becomes subject to section 4947(a)(1). However, for purposes of applying §§ 1.509(a)-4(d)(2)(iv)(*a*), and 1.509(a)-4(i)(1)(ii) and (iii)(*c*) the previous relationship between the charitable trust and the section 509(a)(1) or (2) organizations it benefits or supports may be considered. If the charitable trust otherwise meets the requirements of section 509(a)(3), it may obtain recognition of its status as a section 509(a)(3) organization by requesting a ruling from the Internal Revenue Service. For the special rules pertaining to the application of the organizational test to organizations terminating their private foundation status under the 12-month or 60-month termination period provided under section 507(b)(1)(B) by becoming "public" under section 509(a)(3), see the regulations under section 507(b)(1).

(c) *Split-interest trusts*—(1) *General rule*—(i) *Definition.* For purposes of this section and § 53.4947-2, a "split-interest trust", within the meaning of section 4947(a)(2), is a trust which is not exempt from taxation under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed (within the meaning of paragraph (a) of this section) under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522. A trust is one which has amounts in trust for which a deduction was allowed under section 642(c) within the meaning of section 4947(a)(2) once a deduction is allowed under section 642(c) to the trust for any amount permanently set aside. This (i) also includes any trust which is not treated as a charitable trust by operation of paragraph (b)(2)(iii) or (iv) of this section (relating to split-interest trusts in the process of winding up or during a reasonable period of settlement). Section 4947(a)(1) shall apply to a trust described in this (i) (without regard to section 4947(a)(2)(A), (B), or (C)) from the first date upon which the provisions of paragraph (b)(2)(iii) or (iv) of this section are satisfied. For the circumstances under which a trust all of the unexpired interests in which are devoted to section 170(c)(3) or (5) purposes together with section 170(c)(2)(B) purposes is considered a charitable trust, see § 53.4947-1(b)(2)(vii).

(ii) *Applicability of statutory rules.* A split-interest trust is subject to the provisions of section 507 (except as provided in paragraph (e) of this section), 508(e) (to the extent applicable to a split-interest trust), 4941, 4943 (except as provided in section 4947(b)(3)), 4944 (except as provided in section 4947(b)(3)), and 4945 in the same manner as if such trust were a private foundation.

(iii) *Special rules.* A newly created trust shall for purposes of section 4947(a)(2), be treated as having amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 from the date of its creation, even if a deduction was allowed for such amounts only at a later date. For purposes of this (iii), the date of creation of a charitable remainder trust shall be determined by applying the rules in § 1.664-1(a)(4).

(2) *Exception for amounts payable to income beneficiaries.*—(i) Under section 4947(a)(2)(A), paragraph (c)(1)(ii) of this section does not apply to any amounts payable under the terms of a split-interest trust to income beneficiaries unless a deduction was allowed under section 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B) with respect to the income interest of any such beneficiary. See § 1.170A-6(c), § 20.2055-2(e)(2), and § 25.2522(c)-3(c)(2) for rules regarding the allowance of these deductions. However, section 4947(a)(2)(A) does not apply when the value of all interests in property transferred in trust are deductible under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). H creates a charitable remainder unitrust (described in section 664(d)(2)) which is required annually to pay W, H's wife, 5 percent of the net fair market value of the trust assets, valued annually, for her life; and to pay the remainder to Y, a section 501(c)(3) organization. A deduction under section 170(f)(2)(A) was allowed with respect to the remainder interest of Y. Under section 4947(a)(2)(A), each annual amount which becomes payable to W during her life is not subject to paragraph (c)(1)(ii) of this section on or after the date upon which it becomes so payable and the payment of each amount to W is not an act of self-dealing under section 4941(d)(1) and does not violate any other provision of chapter 42. However, except as provided in the preceding sentence, the trust is subject to paragraph (c)(1)(ii) of this section in the same manner as any other split-interest trust.

Example (2). H bequeaths the residue of his estate in trust for the benefit of S, his son, and Y, an organization described in section 501(c)(3). A guaranteed annuity interest of $10,000 is to be paid to S for 20 years. A guaranteed annuity interest of $5,000 which meets the requirements contained in § 20.2055-2(e)(2)(v)(*a*) is also to be paid to Y for 20 years. Upon termination of the 20-year term, the corpus is to be distributed to Z, another organization described in section 501(c)(3). The trust is a charitable remainder annuity trust as described in section 664(d)(1) and the regulations thereunder, and a deduction under section 2055(e)(2)(A) was allowed with respect to the remainder interest of Z. A deduction was also allowed under section 2055(e)(2)(B) with respect to the guaranteed annuity interest of Y. The assets in the trust are not segregated under section 4947(a)(2)(B) and paragraph (c)(3) of this section. Under section 4947(a)(2)(A), each payment of $10,000 to S is not subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section. The payment of each amount to S is not an act of self-dealing under section 4941(d)(1) and does not violate any other provision of chapter 42. However, except as provided in the preceding sentence, the trust is subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section in the same manner as any other split-interest trust.

Example (3). H creates a trust under which the trustees are required to pay over an annuity interest of $20,000 to W, H's wife, for her life. A guaranteed annuity in-

terest of $10,000 which meets the requirements contained in §25.2522(c)-3(c)(2)(v) is also to be paid to X, an organization described in section 501(c)(3), for the life of W. Upon the death of W, the corpus of the trust, which consists of office buildings M and N, is to be distributed to S, H's son. H received a deduction under section 2522(c)(2)(B) for the value of X's income interest in the trust. The assets in the trust are not segregated under section 4947(a)(2)(B) and paragraph (c)(3) of this section. Under section 4947(a)(2)(A), each payment of $20,000 to W is not subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section. The payment of each amount to W is not an act of self-dealing under section 4941(d)(1) and does not violate any other provision of chapter 42. However, except as provided in the preceding sentence, the trust is subject to paragraph (c)(1)(ii) of this section in the same manner as any other split-interest trust. See example (1) of paragraph (c)(3)(v) of this section for the application of section 4947(a)(2)(B) to a similar trust where the trustees segregate the assets of the trust.

(3) *Exception for certain segregated amounts.*—(i) *In general.* Under section 4947(a)(2)(B), paragraph (c)(1)(ii) of this section does not apply to assets held in trust (together with the income and capital gains derived from the assets), which are segregated from other assets held in trust for which a deduction was allowed for an income or remainder interest under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

(ii) *Segregation of amounts.* Amounts will generally be considered segregated (within the meaning of section 4947(a)(2)(B)) if:

(A) assets with respect to which no deduction was allowed (for an income or remainder interest) under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, are separately accounted for under section 4947(a)(3) and paragraph (c)(4) of this section from assets for which such a deduction was allowed for any income or remainder interest and,

(B) by reason of the separate accounting the trust can be treated as two separate trusts, one of which is devoted exclusively to noncharitable income and remainder interests and the other of which is a charitable trust described in section 4947(a)(1) or a split-interest trust described in section 4947(a)(2).

Under these circumstances, only the "trust" which is devoted exclusively to noncharitable income and remainder interests will be considered a segregated amount which, under section 4947(a)(2)(B), is not subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section.

(iii) *Exclusively charitable amounts.* If, under section 4947(a)(2)(B),

(A) an amount held in trust which is devoted exclusively to noncharitable income and remainder interests is segregated from

(B) an amount held in trust which is devoted exclusively to charitable income and remainder interests,

then for purposes of this section the amount described in paragraph (c)(3)(iii)(B) of this section will be treated as a charitable trust which is subject to the provisions of section 4947(a)(1).

(iv) *Charitable and noncharitable amounts.* If, under section 4947(a)(2)(B),

(A) an amount held in trust which is devoted exclusively to noncharitable income and remainder interests is segregated from

(B) an amount held in trust which is devoted to both charitable income or remainder interests and noncharitable income or remainder interests,

then for purposes of this section the amount described in paragraph(c)(3)(iv)(B) of this section will be treated as a split-interest trust which is subject to the provisions of section 4947(a)(2).

(v) *Examples.* The application of paragraph (c)(3) of this section may be illustrated by the following examples:

Example (1). H creates a trust under which the trustees are required to pay over annually 5 percent of the net fair market value of the M building, valued annually, to W, H's wife, for life, remainder to S, H's son. The other asset in the trust is N building, with respect to which the trustees are required to pay over annually 5 percent of the net fair market value of the building, valued annually, to X, a section 501(c)(3) organization, for a period of 15 years, remainder to S. Each asset is separately accounted for under section 4947(a)(3) and paragraph (c)(4) of this section. H received a deduction under section 2522 for the value of X's income interest in N building. Under these circumstances, M building is considered segregated (within the meaning of section 4947(a)(2)(B)) from N building and is not subject to section 4947(a)(2). The remainder interest of S in N building is not considered segregated from the income interest of X in N building, since both are interests in the same asset. N building is considered held in a split-interest trust which is subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section.

Example (2). H transfers $50,000 in trust to pay $2,500 per year to Z, a section 501(c)(3) organization, for a term of 20 years, remainder to S, H's son. H is allowed a deduction under section 2522 for the present value of Z's income interest. The income interest of Z in the trust asset cannot be segregated (within the meaning of section 4947(a)(2)(B)) from the remainder interest of S since both are interests in the same asset. Therefore, the entire trust is subject to section 4947(a)(2) and paragraph (c)(1)(ii) of this section.

(4) *Accounting for segregated amounts*—(i) *General rule. Under* section 4947(a)(2)(B), a trust with respect to which amounts are segregated within the meaning of paragraph (c)(3) of this section must separately account for the various income, deduction, and other items properly attributable to each segregated amount in the books of account and separately account to each of the beneficiaries of the trust.

(ii) *Method.* Separate accounting shall be made—

(A) According to the method regularly employed by the trust, if the method is reasonable, and

(B) In all other cases in a manner which, in the opinion of the Commissioner, is reasonable.

A method of separate accounting will be considered "regularly employed" by a trust when the method has been consistently followed in prior taxable years or when a trust which has never

before maintained segregated amounts initiates a reasonable method of separate accounting for its segregated amounts and consistently follows such method thereafter. The trust shall keep permanent records and other data relating to the segregated amounts as are necessary to enable the district director to determine the correctness of the application of the rules prescribed in paragraph (c)(3) and (4) of this section.

(5) *Amounts transferred in trust before May 27, 1969*—(i) *General rule.* Under section 4947 (a)(2)(C), paragraph (c)(1)(ii) of this section does not apply to any amounts transferred in trust before May 27, 1969. For purposes of this (5), an amount shall be considered to be transferred in trust only when the transfer is one which meets the requirements for the allowance of a deduction under section 170, 545(b)(2), 556(b)(2), 642 (c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law). Income and capital gains which are derived at any time from amounts transferred in trust before May 27, 1969, shall also be excluded from the application of paragraph (c)(1)(ii) of this section. If an asset which was transferred in trust before May 27, 1969, is sold or exchanged after May 26, 1969, any asset received by the trust upon the sale or exchange shall be treated as an asset which was transferred in trust before May 27, 1969.

(ii) *Requirement for separate accounting for amounts transferred in trust before May 27, 1969.* If:

(A) Amounts are transferred in trust after May 26, 1969, and the trust to which the amounts are transferred also contains

(B) Amounts transferred in trust before May 27, 1969,

the general rule of paragraph (c)(5)(i) of this section applicable to the amounts described in paragraph (c)(5)(ii)(B) of this section will apply only if the amounts described in paragraph (c)(5)(ii)(A) of this section (together with all income and capital gains derived therefrom) are separately accounted for (within the meaning of paragraph (c)(4) of this section) from the amounts described in paragraph (c)(5)(ii)(B) of this section, together with all income and capital gains derived therefrom. For the application of section 508(e) to a trust with respect to which amounts were transferred both before and after May 27, 1969, see section 508(e) and the regulations thereunder.

(iii) *Exception for certain testamentary trusts.* (A) Amounts transferred in trust before May 27, 1969 include amounts transferred in trust after May 26, 1969 when the transfer is made under the terms of a testamentary trust created by the will of a decedent who died before May 27, 1969, (regardless of whether the executors or the testamentary trustees are required to execute testamentary trusts by court order under applicable local law). Amounts transferred in trust before May 27, 1969, also include amounts transferred to a testamentary trust created by the will of a decedent who died after May 26, 1969 if the will was executed before May 27, 1969 and no dispositive provision of the will was amended (within the meaning of § 20.2055-2(e)(4) and (5)) by the decedent by codicil or otherwise, after May 26, 1969, and the decedent was on May 27, 1969, and at all times thereafter under a mental disability (as defined in § 1.642(c)-2(b)(3)(ii)) to amend the will by codicil or otherwise.

(B) The provisions of this (iii) may be illustrated by the following example:

Example. X executed a will in 1960 which provided for the creation of a testamentary trust which meets the description of a split-interest trust under section 4947 (a)(2). X died on April 15, 1969. Under the provisions of his will, the probate court permitted certain property in X's estate to be transferred to the testamentary trust at fixed intervals over a period of two years during the administration of the estate. Section 4947(a)(2) does not apply to any amount described in this example, including the amounts transferred after May 26, 1969, because, for purposes of section 4947 (a)(2)(C), each such transfer will be treated as an amount transferred in trust before May 27, 1969, within the meaning of section 4947(a)(2)(C).

(6) *Scope of application of section 4947(a)(2)*—(i) *In general.* Subject to paragraph (c)(6)(ii), (iii), and (iv) of this section, section 4947(a)(2) applies to trusts in which some but not all unexpired interests are charitable. An estate from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries will not be considered to be a split-interest trust under section 4947(a)(2) during the period of estate administration or settlement, except as provided in paragraph (c)(6)(ii) of this section. A split-interest trust created by will shall be considered a split-interest trust under section 4947(a)(2) as of the date of death of the decedent-grantor, except as provided in paragraph (c)(6)(iv) of this section.

(ii) *Estates.* (A) When an estate from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries is considered terminated for Federal income tax purposes under § 1.641(b)-3(a), then the estate will be treated as a split-interest trust under section 4947(a)(2) (or a charitable trust under section 4947 (a)(1), if applicable) between the date on which the estate is considered terminated under § 1.641(b)-3(a) and the date on which final distribution of the net assets to the last remaining charitable beneficiary is made. This (ii) does not affect the determination of the tax liability under subtitle A of either charitable or noncharitable beneficiaries of the estates.

(B) The provisions of this (ii) may be illustrated by the following example:

Example. X dies on January 15, 1973 and bequeaths $10,000 to M, an organiza-

tion described in section 501(c)(3), and the residue of his estate to W, his wife. A deduction for the charitable bequest was allowed to X's estate under section 2055. Substantially all of X's estate consists of 100 percent of the stock of a wholly owned corporation, certain liquid assets such as marketable stocks and securities and bank accounts, and X's home, automobile, and other personal property. X's will gives his executor a full range of powers, including the power to sell the stock of the wholly owned corporation. After the death of X, his executor continues to manage the wholly owned corporation while attempting to sell the stock of the corporation. During this period, the executor makes no distributions to M. On May 24, 1978, the Internal Revenue Service determines under §1.641(b)-3(a) that the administration of the estate has been unduly prolonged and the estate is considered terminated as of that date for Federal income tax purposes. X's estate will be treated as a split-interest trust described in section 4947(a)(2) between May 24, 1978 and the date on which the $10,000 bequest to M is satisfied. X's estate will therefore be subject to the applicable private foundation provisions during that period and, for example, a sale of the house by the estate to any disqualified person (as defined in section 4946) will be an act of self-dealing under section 4941.

(iii) *Revocable trusts which become split-interest trusts.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor under the terms of the governing instrument of which the trustee is required to hold some or all of its net assets in trust after becoming irrevocable for both charitable and noncharitable beneficiaries is not considered a split-interest trust under section 4947(a)(2) for a reasonable period of settlement after becoming irrevocable except that section 4941 may apply if the requirements of § 53.4941(d)-1(b)(3) are not met. After that period, the trust is considered a split-interest trust under section 4947(a)(2). For purposes of this (iii), the term "reasonable period of settlement" means that period reasonably required (or if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of rights of the subsequent beneficiaries.

(iv) *Certain revocable and testamentary trusts which wind up.* A revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries is not considered a split-interest trust under section 4947(a)(2) for a reasonable period of settlement (within the meaning of paragraph (c)(6)(iii) of this section) after becoming irrevocable. After that period, the trust is considered a split-interest trust under section 4947(a)(2) (or a charitable trust under section 4947(a)(1), if applicable).

(d) *Cross references; Governing instrument requirements and charitable deduction limitations.* For the application of section 642(c)(6) (relating to section 170 limitations on charitable deductions of non-exempt private foundation trusts) to a trust described in section 4947(a)(1), see § 1.642(c)-4. For the denial of a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 for a gift, a bequest, or an amount paid to (and the denial of a deduction under section 642(c) for an amount set aside in) a trust described in section 4947(a)(1) or (2) that fails to meet the applicable governing instrument requirements of section 508(e) by the end of the taxable year of the trust, see section 508(d)(2) and § 1.508-2(b). Since a charitable remainder trust (as defined in section 664) is not exempt under section 501(a), it is subject to section 4947(a)(2), and thus to the governing instrument requirements of section 508(e) to the extent they are applicable.

(e) *Application of section 507(a).* —(1) *General rule.* The provisions of section 507(a) shall not apply to a trust described in section 4947(a)(1) or (2) by reason of any payment to a beneficiary that is directed by the terms of the governing instrument of the trust and is not discretionary with the trustee or, in the case of a discretionary payment, by reason of, or following, the expiration of the last remaining charitable interest in the trust.

(2) *Examples.* The provisions of this (e) may be illustrated by the following examples:

Example (1). H creates a section 4947(a)(1) trust under which the income is to be paid for 15 years to R, a section 501(c)(3) organization. Upon the expiration of 15 years, the trust is to terminate and distribute all of its assets to S, another section 501(c)(3) organization. Distribution of the corpus of the trust to S will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

Example (2). H creates a trust under which X, a section 501(c)(3) organization, receives $20,000 per year for a period of 20 years, remainder to S, H's son. H is allowed a deduction under section 2522 for the present value of X's interest. When the final payment to X has been made at the end of the 20-year period in accordance with the terms of the trust, the provisions of section 4947(a)(2) will cease to apply to the trust because the trust no longer retains any amounts for which the deduction under section 2522 was allowed. However, the final payment to X will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

Example (3). J creates a charitable remainder annuity trust described in section 664(d)(1) under which S, J's son, receives $10,000 per year for life, remainder to be distributed outright to P, an organization described in section 501(c)(3). J is allowed a deduction under section 170 for the value of the remainder interest placed in trust for the benefit of P, and the provisions of section 4947(a)(2) apply to the trust. At the death of S, the trust will terminate and all assets will be distributed to P. However, such final distribution to P will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

§ 53.4947-2 Special rules.

(a) *Limit to segregated amounts.* If any amounts held in trust are segregated within the meaning of § 53.4947-1(c)(3), the value of the net assets for purposes of section 507(c)(2) and (g) shall be limited to the segregated amounts with respect to which a deduction under section

170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 was allowed. See the regulations under section 507(c)(2) and (g).

(b) *Applicability of sections 4943 and 4944 to split-interest trusts*—(1) *General rule.* Under section 4947(b)(3), sections 4943 and 4944 do not apply to a split-interest trust described in section 4947(a)(2) if:

(i) all the income interest (and none of the remainder interest) of the trust is devoted solely to one or more of the purposes described in section 170(c)(2)(B) and all amounts in the trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 have an aggregate value (at the time for which the deduction was allowed) of not more than 60 percent of the aggregate fair market value of all amounts in the trust (after the payment of estate taxes and all other liabilities), or

(ii) a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2) or 2522 for amounts payable under the terms of the trust to every remainder beneficiary, but not to any income beneficiary.

This (1) shall apply to a trust described in paragraph (b)(1)(ii) of this section only if all amounts payable under the terms of the trust to every remainder beneficiary are to be devoted solely to one or more of the purposes described in section 170(c)(2)(B). After the expiration of all income interests in a trust described in paragraph (b)(1)(ii) of this section, the trust shall become subject to section 4947(a)(1) under § 53.4947-1(b)(2), and section 4947(b)(3) shall no longer apply to the trust. A pooled income fund described in section 642(c)(5) will generally meet the requirements of paragraph (b)(1)(ii) of this section, as will a charitable remainder trust described in section 664(d)(1), if in either case it does not make payments to any income beneficiary described in section 170(c).

(2) *Definitions.* (i) For purposes of section 4947(b)(3)(A), the term "income interest" shall include an interest in property transferred in trust which is in the form of a guaranteed annuity interest or unitrust interest as described in § 1.170A-6(c), § 20.2055-2(e)(2) or § 25.2522(c)-3(c)(2) and the term "remainder interests" shall include an interest which succeeds an "income interest" within the meaning of this (i).

(ii) For purposes of section 4947(b)(3)(B), the term "income beneficiary" shall include a recipient of payments described in section 642(c)(5)(F) from a pooled income fund, payments described in section 664(d)(1)(A) from a charitable remainder annuity trust, or payments described in section 664(d)(2)(A) or (3) from a charitable remainder unitrust. The term "remainder beneficiary" shall include a beneficiary of a remainder interest described in section 642(c)(5) or 664(d)(1)(C) or (2)(C).

(c) *Effective date.* Except as otherwise provided in §§ 53.4947-1 and 53.4947-2 and the regulations under sections 508(d) and (e), §§ 53.4947-1 and 53.4947-2 shall take effect on January 1, 1970.

(This Treasury decision is issued under the authority contained in sections 4947 and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved Aug. 16, 1976.
CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed in the office of the Federal Register on August 20, 1976, 8:45 a.m. and published in the issue of the Federal Register for August 23, 1976, 41 F.R. 35514.)

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26 CFR 53.4947-1: Application of tax.

Procedures for issuing rulings and determination letters under section 509(a)(3) of the Code to trusts described in section 4947(a)(1). See Rev. Proc. 76-34, page 656.

Section 4948.—Application of Taxes and Denial of Exemption With Respect to Certain Foreign Organizations

26 CFR 53.4948-1: Application of taxes and denial of exemption with respect to certain foreign organizations.

Whether a Belgian private foundation is subject to the excise tax imposed by section 4948(a) of the Code on its investment income when (1) the United States-Belgium Income Tax Convention reduces the normal 30 percent withholding rate on such income to 15 percent and (2) the Friendship, Establishment, and Navigation Treaty with Belgium prohibits the United States from taxing Belgian companies at rates more burdensome than those imposed on third country nationals. See Rev. Rul. 76-330, page 488.

Chapter 43.—Qualified Pension, etc., Plans

Section 4975.—Tax on Prohibited Transactions

Prohibited Transaction Exemption 76-3

DEPARTMENT OF LABOR

Office of Employee Benefits Security

EMPLOYEE BENEFIT PLANS

Exemption From Prohibitions Respecting a Transaction

The following prohibited transaction exemption was published in the FEDERAL REGISTER (June 25, 1976, 41 F.R. 26291) by the Department of Labor under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, 1974-3 C.B. 1). It is being reprinted here for informational purposes inasmuch as section 4975(c)(2) of the Internal Revenue Code of 1954 confers similar exemption granting authority to the Internal Revenue Service with respect to certain tax qualified employee benefit plans.

Notice is hereby given of the grant-

ing of an exemption under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 (the Act), relating to a transaction involving the use, as a training and storage site, by the Operating Engineers Journeyman and Apprentice Training Trust (the Plan) of a portion of real property owned by Dicco, Inc. ("Dicco"), a contributing employer and party in interest with respect to the Plan.

BACKGROUND AND SUMMARY OF REPRESENTATIONS

On March 26, 1976, notice was published in the FEDERAL REGISTER (41 FR 12739) of a request for exemption from the restrictions of sections 406(a)(1)(A), (C), and (D) of the Act concerning the use by the Plan of certain real property owned by Dicco. The notice invited interested persons to submit comments on the requested exemption to the Department of Labor (the Department). One comment was received with respect to the requested exemption, suggesting that the transaction be considered exempt from section 406 of the Act because it falls within the meaning of section 408(b)(2) of the Act. The comment did not adequately support the suggestion, but will be considered in conjunction with proposed regulations under section 408(b)(2).

The application and documents (the application) submitted by the trustees of the Plan in support of the requested exemption have been available for public inspection at the Department in Washington, D.C. Based upon the application filed by the trustees of the Plan, the Department has decided to grant the requested exemption with respect to the transaction described in such application.

The following is a summary of the facts and representations contained in the application. Interested persons are referred to the application for a complete statement of the facts and the representations of the trustees.

Dicco, a general engineering contractor located in Bakersfield, California, has offered to permit the trustees of the Plan to use a portion of Dicco's 50-acre yard located on James Road approximately ten miles from downtown Bakersfield as a training site for storing engineering equipment and training apprentices and journeymen in the proper techniques of operating such equipment. The yard contains aggregate pits where apprentices and journeymen would operate Plan equipment to obtain experience in dirt moving, compaction, leveling and excavation.

Dicco will not receive any compensation from the trustees of the Plan for the use of the property. However, the trustees will agree to protect, defend and save harmless Dicco from any and all claims and causes of action which may arise from the use of the property by the trustees, Dicco may benefit from the transaction through the availability of better trained workmen and from the activities of journeymen and apprentices during training at the site. Such benefit from the training activities is expected to be slight, if any, because such training normally involves digging, filling, compacting and re-digging at approximately the same location.

The terms of the transaction are set forth in a written agreement between the Plan and Dicco which will be executed upon the granting of this exemption.

The Plan has not had a training site in the Bakersfield, California, area. Since Bakersfield is approximately 90 miles from Los Angeles, California, the absence of a training site in Bakersfield has deprived journeymen and apprentices in that area of the opportunity to participate in training activities of the Plan, which are conducted in Los Angeles County. The purchase or lease of a training site in Bakersfield previously has not been economically feasible because of the relatively few participants in the Bakersfield area.

Notice of the requested exemption, as published in the FEDERAL REGISTER, was given by publication in the April 1976 edition, Vol. XXIX-4, of the International Union of Operation Engineers Local Union No. 12 newspaper, *Engineers News-Record* and distributed to all members of the Union. Copies of the notice of the requested exemption were mailed to the employer associations which are signatories to the trust agreement creating the Plan.

GENERAL INFORMATION

(1) The fact that a transaction is the subject of an exemption granted under section 408(a) of the Act does not relieve a fiduciary with respect to a plan to which the exemption is applicable from certain other provisions of the Act, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with subsection (a)(1)(B) of section 404 of the Act;

(2) The exemption contained herein does not extend to transactions prohibited under sections 406(a)(1)(B) and (E), 406(a)(2) and 406(b) of the Act; and

(3) The exemption set forth herein is supplemental to, and not in derogation of, any other provisions of the Act, including statutory exemptions and transitional rules. Furthermore, the fact that a transaction is the subject of an exemption is not dispositive of whether the transaction would have been a prohibited transaction in the absence of such exemptions or, though it would have been a prohibited transaction, is exempt by operation of a

statutory exemption or a transitional rule.

EXEMPTION

Pursuant to section 408(a) of the Act and the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) and based upon the facts and representations contained in the application for exemption submitted by the trustees of the Plan, the Department finds that it is administratively feasible, in the interest of the Plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the Plan, to grant, and does hereby grant, an exemption, effective June 25th, 1976, so that the restrictions of sections 406(a)(1)(A), (C) and (D) of the Act shall not apply to the use of the real property described above pursuant to the terms, conditions, and representations set forth in the application.

The availability of this exemption is subject to the express conditions that the material facts and representations contained in the application are true and complete and that the application accurately describes all material terms of the transaction to be consummated pursuant to the exemption.

Prohibited Transaction Exemption 76-4

DEPARTMENT OF LABOR

Office of Employee Benefits Security

EMPLOYEE BENEFIT PLANS

Exemption From Prohibitions Respecting a Transaction Involving the Operating Engineers Journeymen and Apprentice Training Trust and R. E. Coulter Gradall Rental, Inc.

The following prohibited transaction exemption was published in the FEDERAL REGISTER (July 16, 1976, 41 F.R. 29502) by the Department of Labor under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, 1974-3 C.B. 1). It is being reprinted here for informational purposes inasmuch as section 4975(c)(2) of the Internal Revenue Code of 1954 confers similar exemption granting authority to the Internal Revenue Service with respect to certain tax qualified employee benefit plans.

Notice is hereby given of the granting of an exemption under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 (the Act), relating to a proposed transaction involving the purchase by the Operating Engineers Journeyman and Apprentice Training Trust (the Plan) of two used excavating machines from R. E. Coulter Gradall Rental, Inc. (Coulter), a contributing employer and a party in interest with respect to the Plan.

BACKGROUND

On April 13, 1976, notice was published in the FEDERAL REGISTER (41 F.R. 15482) of a request for exemption from the restrictions of section 406(a) of the Act concerning the purchase by the Plan of two excavating machines from Coulter. The notice set forth a summary of the facts and representations contained in the application, and referred interested persons to the application for a complete statement of the facts and representations of the Trustees. The notice also invited interested persons to submit comments on the requested exemption to the Department of Labor (the Department). One comment was received urging that the requested exemptions be granted and that plans should be able to purchase goods from a party in interest either pursuant to a class exemption or a statutory exemption under section 408(b)(2) of the Act. The application and documents (the application) submitted by the Trustees of the Plan in support of the requested exemption have been available for public inspection at the Department in Washington, D.C. Based upon the application filed by the Trustees of the Plan and consideration of the public comment, the Department has decided to grant the requested exemption for the transaction described in such application.

Notice of the requested exemption, as published in the FEDERAL REGISTER, was given by publication in the April 1976 edition, Vol. XXIX-4, of the International Union of Operating Engineers Local Union No. 12 newspaper, *Engineers News-Record* which was distributed to all members of the Union on or about April 15, 1976. Copies of the notice of the requested exemption were mailed on May 4, 1976 to the employer associations which are signatories to the trust agreement creating the Plan.

GENERAL INFORMATION

(1) The fact that a transaction is the subject of an exemption granted under section 408(a) of the Act does not relieve a fiduciary with respect to a plan to which the exemption is applicable from certain other provisions of the Act, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with subsection (a)(1)(B) of section 404 of the Act;

(2) The exemption contained herein does not extend to transactions prohibited under section 406(b) of the Act; and

(3) The exemption set forth herein is supplemental to, and not in derogation of, any other provisions of the Act, including statutory exemptions and transitional rules. Furthermore, the fact that a transaction is the subject of an exemption is not dispositive of whether the transaction would have been a prohibited transaction in the

absence of such exemption or, though it would have been a prohibited transaction, is exempt by operation of a statutory exemption or a transitional rule.

EXEMPTION

Pursuant to section 408(a) of the Act and the procedure set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) and based upon the facts and representations contained in the application for exemption submitted by the Trustees of the Plan and consideration of public comment, the Department finds that it is administratively feasible, in the interest of the Plan and its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the Plan, to grant, and does hereby grant, an exemption, effective July 12, 1976, so that the restrictions of section 406 (a) of the Act shall not apply to the purchase of the two excavating machines described in the notice pursuant to the terms, and conditions, and representations set forth in the application.

The availability of the exemption is subject to the express conditions that the material facts and representations contained in the application are true and complete and that the application accurately describes all material terms of the transaction to be consummated pursuant to the exemption.

Prohibited Transaction Exemption 76-5

DEPARTMENT OF LABOR

Office of Employee Benefits Security

EMPLOYEE BENEFIT PLANS

Exemption From Prohibitions Respecting Transaction Involving International Brotherhood of Electrical Workers Local Union No. 606 Health and Welfare Fund.

The following prohibited transaction exemption was published in the FEDERAL REGISTER (July 23, 1976, 41 F.R. 30414) by the Department of Labor under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, 1974-3 C.B. 1). It is being reprinted here for informational purposes inasmuch as section 4975(c)(2) of the Internal Revenue Code of 1954 confers similar exemption granting authority to the Internal Revenue Service with respect to certain tax qualified employee benefit plans.

Notice is hereby given of the granting of an exemption under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 (the Act) relating to a proposed transaction involving an interest free loan of forty thousand dollars ($40,000) to the International Brotherhood of Electrical Workers Local Union No. 606 Health and Welfare Fund (the Plan) from the International Brotherhood of Electrical Workers Local Union No. 606 (the Union) to enable the Plan to pay health insurance premiums to cover Plan participants and beneficiaries.

BACKGROUND

On April 13, 1976, notice was published in the FEDERAL REGISTER (41 F.R. 15481) of a request for exemption from the restrictions of section 406(a) and 406(b)(2) of the Act for the above loan transaction filed by the Trustees of the Plan. The notice sets forth a summary of the facts and representations contained in the application, and referred interested persons to the application for a complete statement of the facts and representations. The notice also invited interested persons to submit comments on the requested exemption to the Department of Labor (the Department). Additionally the notice stated that any interested person may submit a written request that a hearing be held relating to the requested exemption. One comment was received by the Department, urging that the requested exemption be granted and that the Department consider the granting of a class exemption for this type of transaction.

The application and supporting documentation (the application) submitted by the Trustees of the Plan in support of the requested exemption have been available for public inspection at the Department in Washington, D.C.

Based upon the representations and facts submitted in the application and consideration of the public comment, the Department has decided to grant the requested exemption for the transaction described in such application.

Notice of the requested exemption as published in the FEDERAL REGISTER was posted continuously at the Union hall for at least thirty days. Additionally, copies of the FEDERAL REGISTER notice were provided to all Union members and Plan participants by first class mail within 10 days of publication in the FEDERAL REGISTER.

GENERAL INFORMATION

1. The fact that a transaction is the subject of an exemption granted under section 408(a) of the Act does not relieve a fiduciary with respect to a plan to which the exemption is applicable from certain other provisions of the Act, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with subsection (a)(1)(B) of section 404 of the Act;

2. The exemption contained herein does not extend to section 406(b)(1) and (3) of the Act; and

3. This exemption is supplemental to, and not in derogation of, any other provisions of the Act, including statutory exemptions and transitional rules. Further, the fact that a transaction is the subject of an exemption is not dis-

positive of whether the transaction would have been a prohibited transaction in the absence of such exemption or, though it would have been a prohibited transaction, is exempt by operation of a statutory exemption or a transitional rule.

EXEMPTION

Pursuant to section 408(a) of the Act and the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) and based upon the facts and representations contained in the application for exemption submitted by the Trustees of the Plan and consideration of public comment, the Department finds that it is administratively feasible, in the interests of the Plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the Plan to grant, and hereby grants an exemption effective July 19, 1976 so that the restrictions of section 406(a) and 406(b)(2) shall not apply to the interest free loan of $40,000 by the Union to the Plan to enable the Plan to pay health insurance premiums pursuant to the terms, conditions and representations set forth in the application.

The availability of this exemption is subject to the express conditions that the material facts and representations contained in the application are true and complete, and that the application accurately describes all material terms of the transaction when consummated pursuant to the exemption.

Prohibited Transaction Exemption 76-6

DEPARTMENT OF LABOR

Pension and Welfare Benefit Programs

DEPARTMENT OF THE TREASURY

Internal Revenue Service

EMPLOYEE BENEFIT PLANS

Exemption from Prohibitions Respecting a Transaction Involving the Univar Retirement Plan

Notice is hereby given of the granting of an exemption under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] (the Act) and section 4975(c)(2) of the Internal Revenue Code of 1954 (the Code), relating to a proposed transaction involving the sale by the Univar Retirement Plan (the Plan) of 128,751 shares of Univar Corporation (Univar) common stock to Univar.

Background. On July 16, 1976, notice was published in the FEDERAL REGISTER (41 FR 29503) of the pendency before the Department of Labor (the Department) and the Internal Revenue Service (the Service) of a proposed exemption from the restrictions of sections 406(a) and 406(b)(1) and (2) of the Act and sections 4975(a) and (b) of the Code by reason of sections 4975(c)(1)(A) through (E) of the Code concerning the sale by the Plan of Univar common stock to Univar. The notice set forth a summary of the facts and representations contained in the application for exemption submitted by Univar and the Trustees of the Plan and referred interested persons to the application for a complete statement of the facts and representations. The application has been available for public inspection at the Department and the Service in Washington, D.C. No public comments have been received. Based upon the application filed by Univar and the Trustees of the Plan, the Department and the Service have decided to grant the requested exemption for the transaction described in such application. Notice of the requested exemption, as published in the FEDERAL REGISTER, was mailed to each Plan participant and beneficiary, and was posted on bulletin boards which are regularly reviewed by all Plan participants. Each notification referred to above included a copy of the notice of the pending exemption as published in the FEDERAL REGISTER.

General Information. (1) The fact that a transaction is the subject of an exemption granted under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person with respect to a plan to which the exemption is applicable from certain other provisions of the Act and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the Plan participants and beneficiaries and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act, nor does it affect the requirements of section 401(a) of the Code that a plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) The exemption contained herein does not extend to transactions prohibited under section 406(b)(3) of the Act and section 4975(c)(1)(F) of the Code;

(3) The exemption set forth herein is supplemental to, and not in derogation of, any other provision of the Act and the Code, including statutory exemptions and transitional rules, Furthermore, the fact a transaction is the subject of an exemption is not dispositive of whether the transaction would have been a prohibited transaction in the absence of such exemption or, though it would have been a prohibited transaction, is exempt by operation of a statutory exemption or a transitional rule.

Exemption. Pursuant to section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedure set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) and Rev. Proc. 75-26, 1975-1

C.B. 722, and based upon the facts and representations contained in the application for exemption submitted by Univar and the Trustees of the Plan, the Department and the Service find that it is administratively feasible, in the interests of the Plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the Plan, to grant, and does hereby grant, an exemption, effective this date so that the restrictions of sections 406(a) and 406(b)(1) and (2) of the Act and sections 4975(a) and (b) of the Code by reason of sections 4975(c)(1)(A) through (E) of the Code shall not apply to the sale of Univar common stock pursuant to the terms, conditions and representations set forth in the application.

The availability of this exemption is subject to the express conditions that the material facts and representations contained in the application are true and complete and that the application accurately describes all material terms of the transaction to be consummated pursuant to the exemption.

Prohibited Transaction Exemption 76-7

DEPARTMENT OF LABOR

Pension and Welfare Benefit Programs

DEPARTMENT OF THE TREASURY

Internal Revenue Service

EMPLOYEE BENEFIT PLANS

Exemption from Prohibitions Respecting a Transaction Involving Stryco Manufacturing Company Pension Trust, *et al.*

Notice is hereby given of the granting of an exemption under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 (the Act) [Pub. L. 93-406, 1974-3 C.B. 1] and section 4975(c)(2) of the Internal Revenue Code of 1954 (the Code), relating to certain transactions involving an extension of credit by the Stryco Manufacturing Company Pension Trust (the Plan) to Stryco Manufacturing Company (Stryco).

Background. On May 18, 1976, notice was published in the FEDERAL REGISTER (41 FR 20455) (corrected at 41 FR 20940, May 21, 1976) of the pendency of an exemption for certain transactions described in an application submitted by Stryco, 860 Hamilton Corporation (860 Hamilton), Ernest N.C. Moore (Moore), Christian C.E. Hoebich (Hoebich), Dean E. Plankenhorn (Plankenhorn) and Russell C. Arquette (Arquette) collectively referred to as "Applicants"). The notice set forth a summary of the facts and representations contained in the application and referred interested persons to the application for a complete statement of the facts and representations. The notice also invited interested persons to submit comments on the requested exemption to the Department of Labor (the Department). In addition, the notice stated that any interested person might submit a written request that a hearing be held relating to the exemption.

Comments on the pending exemption and a request for a hearing were received by the Department. A hearing with respect to the pending exemption was held by the Department on July 12, 1976. The record of that hearing has been accepted by the Internal Revenue Service (the Service) pursuant to section 4975(c)(2) of the Code.

Written submissions by an interested person and by the Applicants and testimony at the hearing pointed out that under the terms of the May 18, 1976 Notice of Pendency of Exemption, 860 Hamilton could continue making payments to Arquette on a loan made on October 29, 1971, by Arquette to Stryco and on a lease of a machine made on October 1, 1975, by Arquette to 860 Hamilton before the indebtedness to the Plan is liquidated. The loan, which was for a principal amount of $30,000, bears interest at ten percent. Repayment of the loan commenced in May 1975. The initial payment was $750, and subsequent payments of $1,250 have been made each month. The loan will be repaid by August 1977, and, as of September 25, 1976, had an outstanding balance of $12,-389.03. The lease provides that payments of $304.40 per month are to be made for a 36-month period commencing October 1975. The lease yields a return of 9.4 percent, prior to consideration of an interest penalty in excess of $500 incurred by Mr. and Mrs. Arquette in acquiring funds for the purchase of the machine. Under the terms of the exemption herein granted, those payments may be made before the indebtedness is liquidated. However, the terms of the exemption have been revised to provide that no other payments may be made by 860 Hamilton to Stryco or to Mr. or Mrs. Arquette other than those specifically permitted by the terms of the "New Transaction," repayment of the preexisting unsecured loan and payments on the preexisting lease until the indebtedness to the Plan is liquidated.

A participant in and beneficiary of the Plan objected to the exemption, both in written comments and at the hearing, on the grounds that the exemption application fails to demonstrate that the terms of the proposed transactions would be in the interests of the Plan and of its participants and beneficiaries and protective of the rights of participants and beneficiaries of the Plan.

The Department and the Service have considered the objection as well as the comments in favor of granting the exemption and based on those public comments, the representations and facts submitted in the application and the record of the hearing, have decided to grant an exemption as set forth below for the transaction described in the application.

Notice of the pendency of an exemption as published in the FEDERAL

REGISTER was forwarded on May 21, 1976, by registered mail to all beneficiaries of the Plan and to the attorneys for beneficiary Joel C. Harris and the Investment Committee of the Plan.

General information. 1. The fact that a transaction is the subject of an exemption granted under section 408 (a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person with respect to a plan to which the exemption is applicable from certain other provisions of the Act and the Code including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with subsection (a)(1)(B) of section 404 of the Act; nor does it affect the requirement of section 401(a) of the Code that a plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

2. The exemption contained herein does not extend to transactions prohibited under section 406(b)(3) of the Act and 4975(c)(1)(F) of the Code; and

3. This exemption is supplemental to, and not in derogation of, any other provisions of the Act and the Code, including statutory or administrative exemptions and transitional rules. Further, the fact that a transaction is the subject of an exemption is not dispositive of whether the transaction would have been a prohibited transaction in the absence of such exemption or, though it would have been a prohibited transaction, is exempt by operation of a statutory or administrative exemption or a transitional rule.

Exemption. Pursuant to section 408 (a) of the Act and section 4975(c)(2) of the Code and the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) and Rev. Proc. 75-26, 1975-1 C.B. 722, and based upon the facts and representations contained in the application for exemption submitted by the Applicants, the public comments received, and the record of the hearing, the Department and the Service find that it is administratively feasible, in the interests of the Plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the Plan, to grant, and hereby grant, an exemption so that:

(i) effective May 15, 1975, the restrictions of sections 406(a) and 406 (b)(1) and (2) of the Act shall not apply to a transaction described in the Amended Loan Agreement, the Agreement of Purchase and Sale of Assets, Business Support Agreement and related documents as modified by the stipulation dated January 30, 1976, entered into by the Department, Stryco, 860 Hamilton, Moore, Hoebich and Arquette; and

(ii) effective February 13, 1976, the taxes imposed by section 4975(a) and (b) of the Code, by reason of sections 4975(c)(1)(A) through (E) of the Code shall not apply to a proposed transaction described in the Amended Loan Agreement, the Agreement of Purchase and Sale of Assets, Business Support Agreement and related documents as modified by the stipulation dated January 30, 1976, entered into by the Department, Stryco, 860 Hamilton, Moore, Hoebich and Arquette.

The availability of this exemption is subject to the express conditions that 1) other than payments described in the New Transaction no payments shall be made by 860 Hamilton to Stryco or to Mr. or Mrs. Arquette except payments to Mr. Arquette on an unsecured loan made to Stryco on October 29, 1971, and payments on a lease of a machine to 860 Hamilton on October 1, 1975; 2) the material facts and representations contained in the application and the record of the hearing are true and complete; and 3) the application and record accurately describe all material terms of the transaction when consummated pursuant to the exemption.

Prohibited Transaction Exemption 76-8

DEPARTMENT OF LABOR

Pension and Welfare Benefit Programs

Exemption from Prohibitions Respecting a Transaction Involving the Laborers' Training and Retraining Trust Fund for Southern California.

Notice is hereby given of the granting of an exemption under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] (the Act) relating to a proposed transaction involving the construction by parties in interest of permanent training facilities for the Laborers' Training and Retraining Trust Fund for Southern California (the Plan).

Background. On September 28, 1976, notice was published in the FEDERAL REGISTER (41 FR 42717) of the pendency before the Department of Labor (the Department) of a proposed exemption from the restrictions of section 406(a) of the Act concerning the construction by parties in interest of permanent training facilities for the Plan in Rancho Bautista, California. The notice set forth a summary of the facts and representations contained in the application for exemption submitted by the Trustees of the Plan and referred interested persons to the application for a complete statement of the facts and representations. The application has been available for public inspection at the Department in Washington, D.C. No public comments have been received. Based upon the application filed by the Trustees of the Plan, the Department has decided to grant the requested exemption for the transaction described in such appli-

cation. Notice of the requested exemption, as published in the FEDERAL REGISTER, was posted in the union office and hiring hall of each union participating in the Plan and at the administrative office of the Plan. Each notification referred to above included a copy of the notice of the pending exemption as published in the FEDERAL REGISTER.

General Information. (1) The fact that a transaction is the subject of an exemption granted under section 408(a) of the Act does not relieve a fiduciary or other party in interest with respect to a plan to which the exemption is applicable from certain other provisions of the Act, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the Plan participants and beneficiaries and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; (2) The exemption contained herein does not extend to transactions prohibited under section 406 (b) of the Act; (3) The exemption set forth herein is supplemental to, and not in derogation of, any other provisions of the Act, including statutory exemptions and transitional rules. Furthermore, the fact that a transaction is the subject of an exemption is not dispositive of whether the transaction would have been a prohibited transaction in the absence of such exemption or, though it would have been a prohibited transaction, is exempt by operation of a statutory exemption or a transitional rule.

Exemption. Pursuant to section 408(a) of the Act, and in accordance with the procedure set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975), and based upon the facts and representations contained in the application for exemption submitted by the Trustees of the Plan, the Department finds that it is administratively feasible, in the interests of the Plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the Plan, to grant, and does hereby grant, an exemption, effective this date so that the restrictions of sections 406(a) of the Act shall not apply to the construction by parties in interest of permanent training facilities for the Plan in Rancho Bautista, California pursuant to the terms, conditions and representations set forth in the application.

The availability of this exemption is subject to the express conditions that the material facts and representations contained in the application are true and complete and that the application accurately describes all material terms of the transaction to be consummated pursuant to the exemption.

Prohibited Transaction Exemption 76-9

DEPARTMENT OF THE TREASURY

Internal Revenue Service

DEPARTMENT OF LABOR

Pension and Welfare Benefit Programs

Exemption Relating to Transactions Involving the Citizens and Southern National Bank Retirement Trust, et. al.

Notice is hereby given of the granting of an exemption under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] (the Act) and section 4975(c)(2) of the Internal Revenue Code of 1954 (the Code), relating to the sale of common stock of certain correspondent associate banks of the Citizens and Southern Holding Company (Holding Company) which stock the Citizens and Southern National Bank Pension Trust (Pension Trust) and the Citizens and Southern National Bank Profit Sharing Trust (Profit Sharing Trust) have been ordered to divest by the Georgia Commissioner of Banking and Finance.

Background.

On May 25, 1976, notice was published in the FEDERAL REGISTER (41 FR 21383) of the pendency of an exemption from the restrictions of section 406(a) of the Act and from the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A) through (D) of the Code. The notice set forth a summary of the facts and representations contained in an application submitted by the trustees of the Pension Trust and Profit Sharing Trust, and referred interested persons to the application for a complete statement of the facts and representations of the trustees. The notice also invited interested persons to submit comments on the pending exemption to the Internal Revenue Service (the Service). One comment was received which urged that, in the event that it is determined that the price of the shares sold by the escrow agent to disqualified persons or parties in interest is less than the fair market value of such shares at the time of sale, either the Holding Company or the purchaser should pay to the trusts the amount of such deficiency plus interest on such amount from the date of sale to the date of correction. In the summary of representations set forth in the notice, it was stated that the Holding Company will pay the deficiency. However, the application indicates that the deficiency will be paid either by the Holding Company or the purchaser. To clarify the description of this guarantee, the part of the notice which indicates that the Holding Company will pay the deficiency is amended to state that the Holding Company or the purchaser of the stock will pay the deficiency.

The application and the comment

submitted with respect thereto have been available for public inspection at the Service in Washington, D.C. Based upon the application and consideration of the public comment, the Service and the Department of Labor (the Department) have decided to grant an exemption for the transaction described in such application.

Notice of the pendency of the exemption, as published in the FEDERAL REGISTER, was given by publication in the Payday Newsletter which is distributed semi-monthly to all employees of all employer members of the Pension Trust and the Profit Sharing Trust. Additionally, the notice was posted on bulletin boards in all personnel locations of all employers participating in the Trusts and was mailed to all retired participants or beneficiaries who are receiving periodic distributions from either Trust.

General Information. The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption granted under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person with respect to a plan to which the exemption is applicable from certain other provisions of the Act and the Code including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with subsection (a)(1)(B) of section 404 of the Act nor does it affect the requirements of section 401(a) of the Code that a plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) The exemption contained herein does not extend to transactions prohibited under section 406(b) of the Act and section 4975(c)(1)(E) and (F) of the Code; and

(3) The exemption contained herein is supplemental to, and not in derogation of, any other provisions of the Act and the Code, including statutory exemptions and transitional rules. Furthermore, the fact that a transaction is the subject of an exemption is not dispositive of whether the transaction would have been a prohibited transaction in the absence of such exemption or, though it would have been a prohibited transaction, is exempt by operation of a statutory or other exemption or a transitional rule.

Exemption.

Pursuant to section 408(a) of the Act and section 4975(c)(2) of the Code and the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) and Rev. Proc. 75-26, 1975-1 C.B. 722, and based upon the facts and representations contained in the application submitted by the trustees of both the Pension Trust and the Profit Sharing Trust and consideration of the public comment, the Service and the Department find that it is administratively feasible, in the interests of the plans and of their participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plans to grant, and do hereby grant, the exemption set forth below:

The restrictions of section 406(a) of the Act and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (D) of the Code, shall not apply to any sale of Divestiture Stock made pursuant to the escrow agreement dated May 22, 1975, and pursuant to the terms, conditions and representations set forth in the application.

The availability of this exemption is subject to the express conditions that the material facts and representations contained in the application are true and complete, and that the application accurately describes all material terms of the transactions to be consummated pursuant to the exemption.

Prohibited Transaction Exemption 76-10

DEPARTMENT OF THE TREASURY
Internal Revenue Service

DEPARTMENT OF LABOR
Pension and Welfare Benefit Programs

Exemption from Prohibitions Respecting a Transaction Involving the Given International Employees' Stock Bonus Plan (Application No. D-333).

Notice is hereby given to the granting of an exemption under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] (the Act) and section 4975(c)(2) of the Internal Revenue Code of 1954 (the Code), relating to a transaction involving the sale of certain plan assets to the Crocker National Bank (Crocker).

Background. On August 13, 1976, notice was published in the *Federal Register* (41 FR 34384) of the pendency of an exemption for certain transactions described in an application filed by Given International (Given) and the trustee of the Given International Employees' Stock Bonus Plan (Plan). The notice set forth a summary of the facts and representations contained in the application and referred interested persons to the application for a complete statement of the facts and representations. The notice also invited interested persons to submit comments on the requested exemption to the Department of Labor (the Department). In addition, the notice stated that any interested person might submit a written request that a hearing be held relating to the exemption.

A request for a hearing was re-

ceived by the Department. The hearing request, which was submitted on behalf of certain unnamed beneficiaries of the plan, objected to the pending exemption on the grounds that the application did not demonstrate that the proposed transaction is in the interests of the Plan and its participants and beneficiaries or protective of the rights of participants and beneficiaries of the Plan. A hearing with respect to the pending exemption was held by the Department and the Service on October 12, 1976. Neither the person who filed the request for a hearing nor any participant or beneficiary of the Plan appeared at the hearing or submitted any additional written objection to the granting of an exemption. The trustee of the Plan and representatives of Given and of Crocker appeared at the hearing with their counsels and testified in favor of granting the pending exemption.

The Department and the Service have considered the objections as well as the comments in favor of granting the exemption and based on the representations in the application and the record of the hearing, the Department and the Service have decided to grant an exemption as set forth below for the transaction described in the application.

General Information

1. The fact that a transaction is the subject of an exemption granted under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person with respect to a plan to which the exemption is applicable from certain other provisions of the Act and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with subsection (a)(1)(B) of section 404 of the Act; nor does it affect the requirement of section 401(a) of the Code that a plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

2. The exemption contained herein does not extend to transactions prohibited under section 406(b)(3) of the Act and 4975(c)(1)(F) of the Code; and

3. This exemption is supplemental to, and not in derogation of, any other provisions of the Act and the Code, including statutory or administrative exemptions and transitional rules. Further, the fact that a transaction is the subject of an exemption is not dispositive of whether the transaction would have been a prohibited transaction in the absence of such exemption or, though it would have been a prohibited transaction, is exempt by operation of a statutory or administrative exemption or a transitional rule.

Exemption. Pursuant to section 408(a) of the Act and section 4975(c)(2) of the Code and the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) and Rev. Proc. 75-26, 1975-1 C.B. 722, and based upon the facts and representations contained in the application for exemption submitted by the applicants, the public comment received, and the record of the hearing, the Department and the Service find that it is administratively feasible, in the interests of the Plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the Plan to grant, and hereby grants, an exemption effective this date so that the restrictions of sections 406(a) and 406(b)(1) and (2) of the Act and taxes imposed under section 4975(a) and (b) of the Code, by reason of sections 4975(c)(1)(A) through (E) of the Code, shall not apply to the sale by the Plan of the preferred stock of Given to Crocker, pursuant to the terms, conditions and representations set forth in the application.

The availability of this exemption is subject to the express conditions that the material facts and representations contained in the application are true and complete, and that the application accurately describes all material terms of the transaction when consummated pursuant to the exemption.

Prohibited Transaction Exemption 76-11

DEPARTMENT OF LABOR

Pension and Welfare Benefit Programs

Exemption from Prohibitions Respecting a Transaction Involving the Wisconsin Operating Engineers Skill Improvement and Apprenticeship Fund.

Notice is hereby given of the granting of an exemption under the authority of section 408(a) of the Employee Retirement Income Security Act of 1974 [Pub. L. 93-406, 1974-3 C.B. 1] (the Act) relating to a proposed transaction involving the construction for the Wisconsin Operating Engineers Skill Improvement and Apprenticeship Fund (the Plan) of a new training center at Coloma, Wisconsin, by Griese-Ross Construction Company, Inc. (Griese-Ross), a party in interest with respect to the Plan.

Background. In October 15, 1976, notice was published in the FEDERAL REGISTER (41 FR 45642) of the pendency before the Department of Labor (the Department) of an exemption from the restrictions of section 406(a) of the Act for a transaction described in the application submitted by the Trustees of the Plan. The notice set forth a summary of the facts and representations contained in the application for exemption and referred interested persons to the application for a complete statement of the facts and representations. The application has been available for public inspec-

tion at the Department in Washington, D.C. The notice also invited interested persons to submit comments on the requested exemption to the Department. No public comments have been received. Based upon the application filed by the Trustees of the Plan, the Department has decided to grant the requested exemption for the transaction described in the application. Notice of the pendency of an exemption was given by posting copies of the notice published in the FEDERAL REGISTER in the Office of Local 139 of the International Union of Operating Engineers, located in Milwaukee, Wisconsin, and in its District Offices located in the cities of Eau Claire, Madison, and Appleton for at least thirty (30) days beginning within five (5) days after publication of the notice in the FEDERAL REGISTER. Also, copies of the proposed exemption were mailed to the employer associations which are parties to the trust agreement creating and governing the Plan within five (5) days after publication of the notice in the FEDERAL REGISTER.

General Information. (1) The fact that a transaction is the subject of an exemption granted under section 408 (a) of the Act does not relieve a fiduciary or other party in interest with respect to a plan to which the exemption is applicable from certain other provisions of the Act, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the Plan participants and beneficiaries and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act;

(2) The exemption contained herein does not extend to transactions prohibited under section 406(b) of the Act;

(3) The exemption set forth herein is supplemental to, and not in derogation of, any other provision of the Act, including statutory exemptions and transitional rules. Furthermore, the fact that a transaction is the subject of an exemption is not dispositive of whether the transaction would have been a prohibited transaction in the absence of such exemption or, though it would have been a prohibited transaction, is exempt by operation of a statutory exemption or a transitional rule.

Exemption. Pursuant to section 408 (a) of the Act, and in accordance with the procedure set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) and based upon the facts and representations contained in the application for exemption submitted by the Trustees of the Plan, the Department finds that it is administratively feasible, in the interests of the Plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the Plan, to grant, and does hereby grant, an exemption, effective this date, so that the restrictions of section 406(a) of the Act shall not apply to the construction of a new training center at Coloma, Wisconsin by Griese-Ross pursuant to the terms, conditions and representations set forth in the application.

The availability of this exemption is subject to the express conditions that the material facts and representations contained in the application are true and complete and that the application accurately describes all material terms of the transaction to be consummated pursuant to the exemption.

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26 CFR 141.4975-13: Definition of "taxable period," "amount involved," "correction," and "correction period."

T.D. 7425

TITLE 26—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER D, PART 141—TEMPORARY EXCISE TAX REGULATIONS UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Definition of certain terms in the prohibited transaction provisions

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER
OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

This document amends the Temporary Excise Tax Regulations under the Employee Retirement Income Security Act of 1974 (26 CFR Part 141) by adding § 141.4975-13. This new section prescribes temporary use of 26 CFR 53.4941(e)-1 (Foundation Excise Tax Regulations relating to foundation self-dealing taxes) for matters involving the terms which appear both in section 4941(e) of the Internal Revenue Code of 1954 (the Code) (relating to foundation self-dealing) and section 4975(f) of the Code (relating to employee benefit plan prohibited transactions). These terms are: "taxable period," "amount involved," "correction," and "correction period." These regulations will be effective until superseded by permanent regulations under the relevant paragraphs of section 4975(f). No inferences should be drawn from these temporary regulations concerning the contents of permanent regulations, which have not yet been proposed.

Accordingly, Part 141 of the Temporary Excise Tax Regulations under the Employee Retirement Income Security Act of 1974 are amended by adding the following new section:

§ 141.4975-13 Definition of "taxable period," "amount involved," "correction," and "correction period".

Until superseded by permanent regulations under sections 4975(f)(2), (4), (5) and (6), § 53.4941(e)-1 of

this chapter (Foundation Excise Tax Regulations) will be controlling to the extent such regulations describe terms appearing both in section 4941(e) and section 4975(f).

Because of the need for immediate guidance with respect to the provisions contained in this Treasury decision, it is found impracticable to issue it with notice and public procedure thereon under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved July 30, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 5, 1976, 8:45 a.m., and published in the issue of the Federal Register for August 6, 1976, 41 F.R. 32890.)

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26 CFR 141.4975-14: Election to pay an excise tax for certain pre-1975 prohibited transactions.

T.D. 7424

TITLE 26—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER D, PART 141—TEMPORARY EXCISE TAX REGULATIONS UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Temporary regulations relating to the election to pay an excise tax for certain pre-1975 prohibited transactions

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

This document contains Temporary Excise Tax Regulations under the Employee Retirement Income Security Act of 1974 [1974-3 C.B. 1] (26 CFR Part 141) under section 2003(c)(1)(B) of such Act, which provides an election to pay an excise tax under section 4975 of the Internal Revenue Code of 1954 for certain pre-1975 transactions. They supersede guidelines announced in Technical Information Release 1450 [Announcement 76-59, 1976-17 I.R.B. 33] on March 23, 1976.

Under § 141.4975-14 of these regulations the election is available for persons who, before January 1, 1975, engaged in transactions which were prohibited transactions within the meaning of sections 503(b) and (g) of the Code. Making the election results in the nonapplication of a denial of exempt status under section 501(a) on account of the transaction with respect to which the election is made. However, making the election has no effect on the application of section 6501 (relating to limitations on the assessment and collection of tax) and section 6511 (relating to limitations on the filing of a claim for credit or refund) to taxpayers affected by the nonapplication of a denial of exempt status.

The election is made by filing the form and paying the tax that the taxpayer claims thereon is due in the manner prescribed in these temporary regulations. Only a person making an election is liable for the taxes resulting from the election. The amount of tax and what constitutes correction are computed as if section 4975 had been in effect at the time of the transaction. For purposes of determining the amount of tax and what constitutes correction, regulations in the private foundation area are incorporated by reference. However, except as necessary for such purposes, taxpayers are advised that no inference should be drawn from these regulations regarding questions arising under section 4975 with respect to prohibited transactions occurring after December 31, 1974.

Accordingly, TIR-1450 is hereby superseded; 26 CFR is amended by adding a new Part 141, entitled Temporary Excise Tax Regulations under the Employee Retirement Income Security Act of 1974; and a new §141.4975-14 is added as follows:

§ 141.4975-14 Election to pay an excise tax for certain pre-1975 prohibited transactions.

(a) *In general.* Section 2003(c)(1)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978) provides an election to pay an excise tax by certain persons involved prior to 1975 in prohibited transactions within the meaning of section 503(b) or (g).

(b) *Effect of election.* If a valid election is made under this section with respect to a particular transaction, any loss of exemption under section 501(a) because of a prohibited transaction within the meaning of section 503(b) or (g) shall not apply. Instead, the person who made the election referred to in this section shall be subject to the taxes which would have been imposed by section 4975(a) or (b) as though section 4975 had imposed a tax in respect of the transaction. (However, section 4975(f)(1), relating to joint and several liability, shall not apply to any person who has not made an election under this section, and interest for late payment of tax shall not begin to accrue until after the date of the election.) Such an election is irrevocable. However, the making of the election does not affect the application of section 6501 for purposes of assessment and collection of tax and section 6511 for purposes of filing a claim for credit or refund with respect to taxpayers and to

taxable years of taxpayers whose tax liability is or may be affected by reason of the nonapplication of a denial of exempt status.

(c) *Method of election.* A person shall make the election referred to in this section by filing the form issued for such purpose by the Internal Revenue Service, including therein the information required by such form and the instructions issued with respect thereto, and by paying the tax which the taxpayer indicates is due at the time the return is filed. To be valid the election must be made prior to the later of December 6, 1976, or 120 days after the date of notification referred to in § 1.503(a)-1(b) of this chapter (Income Tax Regulations), relating to loss of exemption for certain prohibited transactions. If there has been no notification of loss of exemption, the election may be made at any time.

(d) *Computation of section 4975 excise tax.* To the extent applicable, and solely for purposes associated with the payment of a section 4975 excise tax under the election referred to in this section, § 53.4941(e)-1 of this chapter (Foundation Excise Tax Regulations) is controlling.

Because of the need for immediate guidance with respect to the provisions contained in this Treasury decision, it is found impracticable to issue it with notice and public procedure thereon under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

(This Treasury decision is issued under the authority contained in section 2003(c)(1)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978) and section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved July 30, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 5, 1976, 8:45 a.m., and published in the issue of the Federal Register for August 6, 1976, 41 F.R. 32889.)

Subtitle F.—Procedure and Administration
Chapter 61.—Information and Returns
Subchapter A.—Returns and Records
Part I.—Records, Statements, and Special Returns

Section 6001.—Notice or Regulations Requiring Records, Statements, and Special Returns

26 CFR 1.6001-1: Records.

Conditions for the reproduction of certain Federal tax return forms and schedules. See Rev. Proc. 76-40, page 662.

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26 CFR 1.6001-1: Records.

Conditions for computer-prepared Form 1040 and related schedules. See Rev. Proc. 76-41, page 665.

Part II.—Tax Returns or Statements
Subpart A.—General Requirement

Section 6011.—General Requirement of Return, Statement, or List

26 CFR 1.6011-1: General requirement of return, statement, or list.

Requirements and conditions under which magnetic tape records may be submitted. See Rev. Proc. 76-38, page 661.

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26 CFR 1.6011-1: General requirements of return, statement, or list.

Conditions for the reproduction of certain Federal tax return forms and schedules. See Rev. Proc. 76-40, page 662.

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26 CFR 1.6011-1: General requirements of return, statement, or list.

Conditions for computer-prepared Form 1040 and related schedules. See Rev. Proc. 76-41, page 665.

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26 CFR 49.6011(a)-1: Returns. (Also Section 4251; 49.4251-1.)

Returns; communications tax; reporting. The repeal of certain taxes by the Excise Tax Reduction Act of 1965, and a change in Form 720, makes the conclusions of Rev. Rul. 60-7 inapplicable to the reporting of separate categories of communications taxes on Form 720; Rev. Rul. 60-7 superseded.

Rev. Rul. 76-560

The Internal Revenue Service has reviewed Rev. Rul 60-7, 1960-1 C.B. 614, which relates to a method to be used by certain telephone companies for reporting on Form 720, Quarterly Federal Excise Tax Return, the collected Federal excise taxes on amounts paid by customers to the companies for communications services.

Rev. Rul. 60-7 deals with telephone companies that operate under the Uniform System of Accounts prescribed by the Federal Communications Commission. Under that system the companies maintain subaccounts in which are recorded all items of Federal excise taxes on communications services that are billed to or otherwise collected from subscribers. Items of adjustment are also recorded in the subaccounts to reflect the net tax due for a given month for purposes of Form 720.

At the time of publication of Rev. Rul. 60-7, the Form 720 required that separate entries be made for the various categories of communications taxes then in effect. Under the Excise Tax Reduction Act of 1965, Pub.L. 89-44, 1965-2 C.B. 568, at 577, section 4251 of the Internal Revenue Code of 1954 was amended to repeal the tax on telegraph service, wire mileage service, and wire and equipment service and to change the tax on general telephone service to local telephone service. Subsequently, the Form 720 was revised to eliminate the requirement that the communications taxes be entered in separate categories. Only one entry for the total communications taxes is now required. Consequently, the conclusions set forth in Rev. Rul.

60-7 regarding the separate category requirement are no longer pertinent. However, the other conclusions in Rev. Rul. 60-7 regarding the reporting of communications taxes on Form 720 are still applicable. These conclusions are restated in Rev. Proc. 76-45, page 668, this Bulletin, which sets forth the method for reporting communications taxes under current law and repulations.

Rev. Rul. 60-7 is superseded.

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26 CFR 49.6011(a)-1: Returns.

A method to be used by telephone companies, that keep their records in accordance with the Uniform System of Accounts prescribed by the Federal Communications Commission, for reporting, on Form 720, collected Federal excise taxes on communications services. See Rev. Proc. 76-45, page 668.

Subpart B.—Income Tax Returns

Section 6013.—Joint Returns of Income by Husband and Wife

Date of death, for members of the Armed Forces of the United States or civilian employees who are prisoners of war or missing in action, for purposes of determining spouse's eligibility to file joint returns of income under section 6013 of the Code. See Rev. Rul. 76-468, page 202.

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26 CFR 1.6013-4: Applicable rules.

Status of two individuals as husband and wife. See Rev. Rul. 76-255, page 40.

Section 6015.—Declaration of Estimated Income Tax By Individuals

26 CFR 1.6015(a)-1: Declaration of estimated income tax by individuals.

Whether the fact that a change in accounting period would provide a taxpayer with information for making a more accurate fourth quarter estimated payment is a substantial business purpose for the granting of a change in accounting period under section 1.442-1(b) of the regulations. See Rev. Rul. 76-407, page 127.

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26 CFR 1.6015(b)-1: Joint declaration by husband and wife.

Joint declaration of estimated tax by husband and wife who have self-employment income subject to self-employment tax. See T.D. 7427, page 431.

Subpart C.—Estate and Gift Tax Returns

Section 6018.—Estate Tax Returns

26 CFR 20.6018-1: Returns.

Conditions for the reproduction of certain Federal tax returns forms and schedules. See Rev. Proc. 76-40, page 662.

Section 6019.—Gift Tax Return

26 CFR 25.6019-1: Persons required.

Conditions for the reproduction of certain Federal tax return forms and schedules. See Rev. Proc. 76-40, page 662.

Subpart D.—Miscellaneous Provisions

Section 6020.—Returns Prepared For or Executed by Secretary

26 CFR 301.6020-1: Returns prepared or executed by district directors or other internal revenue officers.

Whether the delinquency period for the purpose of computing the addition to the tax under section 6651(a)(1) stops running when a return is prepared under section 6020(b) and whether the addition to the tax under section 6651(a)(2) applies when a return is prepared under section 6020(b). See Rev. Rul. 76-562, page 430.

Part III.—Information Returns
Subpart B.—Information Concerning Transactions with Other Persons

Section 6049.—Returns Regarding Payments of Interest

26 CFR 301.6049-1: Returns regarding payments of interest.
(Also Sections 451, 1232; 1.451-2, 1.1232-1.)

Information returns; time savings certificates. No Form 1099-OID is required for interest on a financial institution's time savings certificates that are not offered at a discount, are redeemable on any two-year anniversary during their ten-year life without penalty, and bear simple interest at six percent per annum paid or made available quarterly. However, the interest must be reported on Form 1099-INT.

Rev. Rul. 76-449

Advice has been requested whether, under the circumstances described below, interest earned on time savings certificates is to be reported as original issue discount on Form 1099-OID, U.S. Information Return for Original Issue Discount.

A financial institution makes available to depositors time savings certificates for terms of two to ten years that have a multiple maturity feature permitting redemption on any two year anniversary. These certificates bear simple interest at the rate of 6 percent per annum; interest is paid or made available to depositors quarterly. The certificates must be held for two years or be subject to a penalty in accordance with Regulation Q of the Federal Reserve Board and Federal Deposit Insurance Corporation regulations, 12 CFR 217 (amended July 5, 1973). The financial institution annually reports the interest accrued during the calendar year to the certificate holder. The certificates are not offered at a discount.

Section 1232(b) of the Code provides that the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity.

Section 1.1232-3(b)(1)(iii) of the Income Tax Regulations provides that the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement, including dividends, interest, and any other amounts, however designated, payable at that time. If any amount based on a fixed rate of simple or compound interest is actually payable or will be treated as constructively received under section 451 and the regulations thereunder at fixed periodic intervals of one year or less during the entire term of the obligation, then any such amount payable at ma-

turity will not be included in the stated redemption price at maturity.

Section 1.451-2(a) of the regulations provides that income is constructively received by a taxpayer during the taxable year in which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Section 1.451-2(a)(2) of the regulations provides that the fact that the taxpayer would, by not withdrawing the earnings until a later date, receive a higher rate of earnings than would be payable if the earnings are withdrawn during the taxable year is not a substantial limitation or restriction.

Section 1.6049-1(a) of the regulations provides that interest paid by banks must be reported on Form 1099-INT, U.S. Information Return for Recipients of Interest Income, and Form 1096, U.S. Annual Information Return, and original issue discount must be reported on Form 1099-OID and Form 1096 ratably over the term of the certificate.

Forfeiture penalties, similar to those under Regulation Q, are not considered to be substantial limitations or restrictions. See Rev. Rul. 73-511, 1973-2 C.B. 402, and Rev. Rul. 75-21, 1975-1 C.B. 367, which set forth guidelines for reporting by financial institutions of interest and forfeiture penalties on Form 1099-INT.

In the instant case, there is no substantial limitation or restriction imposed by the financial institution on the withdrawal of funds from an account. Therefore, the interest earned will be treated as constructively received under section 451 of the Code and the regulations thereunder so that no such amount payable at maturity will be included in the stated redemption price at maturity. Since the certificates are not issued to the public at a discount and the interest earned is not included in the stated redemption price at maturity, no original issue discount exists because the difference between the issue price and the stated redemption price at maturity is zero.

Accordingly, since in the instant case there is no original issue discount, no Form 1099-OID is required to be filed. However, any interest earned is required to be reported on Form 1099-INT.

Part V.—Time for Filing Returns and Other Documents

Section 6072.—Time For Filing Income Tax Returns

26 CFR 1.6072-1: Time for filing returns of individuals, estates, and trusts.

T.D. 7426

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Time for filing income tax returns of foreign trusts.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER
OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) in order to provide in the regulations that the filing requirements for income tax returns (including unrelated business tax returns) of certain foreign trusts will be the fifteenth day of the sixth month following the close of the trust's taxable year.

The purpose of this amendment is to clarify the regulations and to end an apparent conflict between the regulations and the instructions to Forms 990 T and 1040 NR.

Amendment to the regulations

The Income Tax Regulations (26 CFR Part 1) are amended as follows:

Paragraph 1. Paragraphs (a) and (c) of § 1.6072-1 are amended to read as follows:

§ 1.6072-1 Time for filing returns of individuals, estates, and trusts.

(a) *In general.* Except as provided in paragraphs (b) and (c) of this section, returns of income required under sections 6012, 6013, 6014, and 6017 of individuals, estates, domestic trusts, and foreign trusts having an office or place of business in the United States (including unrelated business tax returns of such trusts referred to in section 511(b)(2)) shall be filed on or before the fifteenth day of the fourth month following the close of the taxable year.

* * * * *

(c) *Nonresident alien individuals and foreign trusts.* The income tax return of a nonresident alien individual and of a foreign trust which does not have an office or place of business in the United States (including unrelated business tax returns of such trusts referred to in section 511(b)(2)) shall be filed on or before the fifteenth day of the sixth month following the close of the taxable year. However, a nonresident alien individual who for the taxable year has wages subject to withholding under chapter 24 of the Code shall file his income tax return on or before the fifteenth day of the fourth month following the close of the taxable year.

* * * * *

Because this Treasury decision amends existing regulations by providing rules relating to administrative practice and procedure, it is found unnecessary to issue it with notice and public procedure thereon under 5 U.S.C. 553(b) or subject to the effective date limitations of 5 U.S.C. 553(d).

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved August 3, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury

(Filed by the Office of the Federal Register on August 6, 1976; 8:45 a.m., and published in the issue of the Federal Register for August 9, 1976, 41 F.R. 33262)

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26 CFR 1.6072-1: Time for filing returns of individuals, estates, and trusts.

Whether the time to be disregarded by members of the Armed Forces of the United States under section 7508 of the Code for purposes of filing income tax returns and determining period of limitations on assessment and collection includes any unexpired compliance time for each taxable year that the taxpayer was in a combat zone. See Rev. Rul. 76-425, page 447.

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26 CFR 1.6072-2: Time for filing returns of corporations.

Whether interest can be imposed under section 6601 of the Code on an underpayment of tax that resulted from an adjustment under section 815(d)(2)(A). See Rev. Rul. 76-383, page 429.

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26 CFR 1.6072-2: Time for filing returns of corporations.

Whether the relief provisions of section 1.1502-75(b)(3) of the regulations are applicable when the common parent of an affiliated group has failed to timely file the group's consolidated return. See Rev. Rul. 76-393, page 255.

Part VI.—Extension of Time for Filing Returns

Section 6081.—Extension of Time for Filing Returns

26 CFR 1.6081-1: Extension of time for filing returns.

Whether the relief provisions of section 1.1502-75(b)(3) of the regulations are applicable when the common parent of an affiliated group has failed to timely file the group's consolidated return. See Rev. Rul. 76-393, page 255.

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26 CFR 301.6081-1: Extension of time for filing returns.

Whether the relief provisions of section 1.1502-75(b)(3) of the regulations are applicable when the common parent of an affiliated group has failed to timely file the group's consolidated return. See Rev. Rul. 76-393, page 255.

Chapter 62.—Time and Place for Paying Tax
Subchapter A.—Place and Due Date for Payment of Tax

Section 6151.—Time and Place for Paying Tax Shown on Returns

26 CFR 1.6151-1: Time and place for paying tax shown on returns.

Whether interest can be imposed under section 6601 of the Code on an underpayment of tax that resulted from an adjustment under section 815(d)(2)(A). See Rev. Rul. 76-383, page 429.

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26 CFR 20.6151-1: Time and place for paying tax shown on the return.

Whether the voluntary transfer of real property to the Federal Government is an acceptable method of payment of Federal taxes under the provisions of the Internal Revenue Code. See Rev. Rul. 76-350, page 396.

Section 6152.—Installment Payments

26 CFR 1.6152-1: Installment payments.

Whether a corporation is entitled to the installment privilege when it makes timely estimated tax payments representing excess tax liability and receives refunds of such excess. See Rev. Rul. 76-493, page 429.

Section 6154.—Installment Payments of Estimated Income Tax By Corporations

26 CFR 1.6154-1: Corporations required to pay estimated income tax.

Whether there is an underpayment of estimated tax within the meaning of section 6655(b) of the Code if the taxpayer's fourth installment period payment is at least 25 percent of 80 percent of the tax shown on the return for the year. See Rev. Rul. 76-563, page 445.

Chapter 64.—Collection
Subchapter A.—General Provisions

Section 6302.—Mode or Time of Collection

26 CFR 31.6302(c)-1: Use of Government depositories in connection with taxes under Federal Insurance Contributions Act and income tax withheld.

Government depositary; deposits. The employer who withheld $1,000 from wages for the quarter-monthly period July 1 through July 7 and on July 11 deposited $5,000 which represented the entire amount of taxes withheld on bonuses paid that day was not required under section 31.6302(c)-1(a)(i)(*b*) of the regulations to deposit the $1,000 at the close of the quarter-monthly period ending July 15 because the aggregate amount of undeposited taxes was less than $2,000.

Rev. Rul. 76-561

For the quarter-monthly period July 1 through July 7, a taxpayer withheld $1,000 from employees' wages. On July 11, the taxpayer deposited $5,000 which represented the entire amount of taxes withheld on bonuses paid on that date. No deposit was made at the close of the quarter-monthly period ending July 15 because no other wages were paid during that period and the aggregate amount of undeposited taxes withheld as of the close of such period was only $1,000.

Section 6302(c) of the Internal Revenue Code of 1954 provides that the Secretary or the Sercetary's delegate may authorize Federal Reserve banks, and incorporated banks or trust companies that are depositaries or financial agents of the United States, to receive any tax imposed under the Internal Revenue laws in such manner, at such times, and under the conditions prescribed.

Section 31.6302(c)-1(a)(1)(i)(*b*) of the Employment Tax regulations

states that an employer must deposit withheld taxes within three banking days after the close of any quarter-monthly period if, at the close of that period, the aggregate amount of undeposited taxes required to be withheld is $2,000 or more. The regulation defines the term "quarter-monthly period" to mean the first 7 days of a calendar month, the 8th day through the 15th day, the 16th day through the 22nd day, and any portion of the calendar month following the 22nd day.

Held, the taxpayer is not subject to the deposit requirements prescribed by section 31.6302(c)-1(a)(1)(i)(*b*) of the regulations because the amount of undeposited taxes withheld as of the close of the quarter-monthly period ending July 15 was less than $2,000.

Subchapter B.—Receipt of Payment

Section 6311.—Payment by Check or Money Order

26 CFR 301.6311-1: Payment by check or money order.
(Also Sections 6151, 7506; 20.6151-1; 301.7506-1.)

Payment of tax; method of payment. A transfer of real property to the Federal Government is not an acceptable method of payment of Federal taxes; they must be paid in money or its equivalent.

Rev. Rul. 76-350

Advice has been requested whether the voluntary transfer of real property to the Federal government is an acceptable method of paying Federal taxes.

Title 31 of the United States Code, 31 U.S.C. 392 (1970), provides that all coins and currencies of the United States shall be legal tender for all debts, public and private, including taxes.

Section 6311 of the Internal Revenue Code of 1954 permits the Internal Revenue Service to accept checks or money orders in payment of Internal Revenue taxes. Section 6316 and the regulations thereunder permit the Service to accept, under certain circumstances, foreign currencies in payment of Internal Revenue taxes. Section 6151 does not prescribe the method of paying Federal taxes; however pursuant to specific statutory authority, section 20.6151-1(c) of the Estate Tax Regulations does permit payment of Federal estate taxes with certain United States Treasury bonds issued before March 4, 1971, and owned by the decedent at death. See section 31 U.S.C. 765.

Section 7506(a) of the Code provides that the Secretary or the Secretary's delegate shall have charge of all real estate which is or shall become the property of the United States by judgment of forfeiture under the internal revenue laws, or which has been or shall be assigned, set off, or conveyed by purchase or otherwise to the United States in payment of debts or penalties arising under the laws relating to internal revenue, or which has been or shall be vested in the United States by mortgage or other security for the payment of such debts, or which has been redeemed by the United States, and of all trusts created for the use of the United States in payment of such debts due them.

There is no provision of Federal law under which taxes may be paid by a voluntary transfer of real or personal property to the Federal government. Tangible property is not legal tender. Section 7506 of the Code does not authorize the voluntary acceptance of land by the Federal government in lieu of legal tender for Federal taxes, but merely provides for the administration of real property acquired by the Federal government. Even when the United States seizes property in connection with the satisfaction of tax liability, section 6335 and the regulations thereunder provide for the liquidation of the liability through public auction of the property so seized. In addition, section 7506 of the Code provides for the sale or lease of property acquired as described in that section. The clear intent of Federal law is that taxes are to be paid in money or its equivalent. See *Calafut v. United States,* 277 F. Supp. 266 (M.D. Pa. 1967).

Accordingly, a transfer of real property to the Federal government is not an acceptable method of paying Federal taxes.

Subchapter C.—Lien for Taxes

Section 6323.—Validity and Priority Against Certain Persons

26 CFR 301.6323(a)-1: Purchasers, holders of security interests, mechanic's lienors, and judgment lien creditors.
(Also Section 6325; 301.6325-1.)

T.D. 7429[1]

TITLE 26.—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER A, PART 1.—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953; SUBCHAPTER B, PART 20.—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954; PART 25.—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954; SUBCHAPTER F, PART 301.—PROCEDURES AND ADMINISTRATION

Priority of lien; release of lien or discharge of property

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C., 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

On January 4, 1973, a notice of proposed rule making to conform the

[1] This publication of the Treasury Decision contains the full text of the regulations. The individual instructions for modifying the notice of proposed rulemaking have been omitted.

Income Tax Regulations (26 CFR Part 1), the Estate Tax Regulations (26 CFR Part 20), the Gift Tax Regulations (26 CFR Part 25), and the Regulations on Procedure and Administration (26 CFR Part 301) under sections 545, 6323, and 6325 of the Internal Revenue Code of 1954 (relating to priority of lien and release of lien or discharge of property) to changes made by section 236 of the Revenue Act of 1964 (78 Stat. 127) [Pub. L. 88-272, 1964-1 (Part 2) C.B. 6], section 17 (a) of Public Law 89-493 (80 Stat. 263) [1966-2 C.B. 594], and sections 101 and 103 of the Federal Tax Lien Act of 1966 (80 Stat. 1125 and 1133) [Pub. L. 89-719, 1966-2 C.B. 623] was published in the Federal Register (38 F.R. 776).

Section 6323 generally relates to the validity and priority of a Federal tax lien against certain persons. Section 301.6323(b)-1(d) of the proposed regulations provided that a previously filed notice of tax lien is not valid against a purchaser who buys (for less than $250 and not for resale) household goods, personal effects or certain other tangible personal property in a casual sale, provided the purchaser does not have actual notice or knowledge of (A) the existence of a tax lien, or (B) that the sale is one of a series of sales.

No definitive rule was developed in the proposed regulations to determine, under all circumstances, when a purchaser would be considered to have notice or knowledge that the sale was one of a series of sales. However, example (3) of proposed § 301.6323(b)-1(d) illustrated a situation where a purchaser would be considered to have such notice. In this example the seller advertised the sale of substantially all his household property. In response to the advertisement the buyer purchased the seller's dining room furniture for $200. The purchase occurred after a notice of tax lien was filed. The example concluded that because such an advertisement contemplated a series of sales to dispose of substantially all the seller's household articles, the purchaser had notice that the sale was one of a series of sales and, consequently, purchased the dining room furniture subject to the tax lien.

After reconsideration, it was concluded that whether a particular purchaser would be considered to have such actual notice or knowledge would depend upon that purchaser's background and experience. Consequently, example (3) of proposed § 301.6323(b)-1(d) is not contained in the final regulations.

Section 301.6323(c)-1(b) and (d) of the proposed regulations have been revised. Section 301.6323(c)-1(b) contained a definition of the term "commercial transactions financing agreement" for purposes of the priority rules of section 6323(c). In addition to other requirements relating to such agreements, protection of a security interest in "qualified property" against a tax lien is provided only with respect to advances made under such an agreement before the 46th day after the date of tax lien filing or, if earlier, the time when the lender or purchaser has actual notice or knowledge of tax lien filing. Section 6323(c)(2)(B) provides that "qualified property" under a commercial transactions financing agreement includes only property acquired by the debtor-taxpayer before the 46th day after the date of tax lien filing. Thus, there are two 45-day rules relating to commercial transactions financing agreements, *i.e.*, one relating to the period during which advances must be made by the creditor or purchaser and another relating to the period during which the property or collateral must be acquired by the debtor-taxpayer. The acquisition of notice or knowledge of the tax lien by the creditor shortens one of the periods (the one relating to advances) but not the other (the one relating to the acquisition of the collateral). Proposed § 301.6323(c)-1(b) had contained both the 45-day rules. In the interest of clarification, § 301.6323(c)-1(b) and (d) have been revised so that the 45-day rule relating to advances appears in § 301.6323(c)-1(b) of the final regulations (relating to commercial transactions financing agreement) and the 45-day rule relating to the acquisition of the collateral appears in § 301.6323(c)-1(d) of the final regulations (relating to qualified property).

Sections 301.6323(c)-1(d) and 301.6323(d)-1(a) of the proposed regulations have been revised to reflect a change of position with respect to the acquisition of contract rights.

The proposed regulations provided that contract rights are considered to be "acquired" when, and to the extent that, a right to payment is earned by performance. This position was taken in proposed § 301.6323(c)-1(d), relating to the specific protection provided a security interest in qualified property under a commercial transactions financing agreement, and § 301.6323(d)-1(a), relating to the general protection provided with respect to advances made after tax lien filing under an agreement entered into before such filing. However, after considering comments received from the public, the final regulations have been revised to provide that: for purposes of § 301.6323(c)-1(b), a contract right is acquired by the taxpayer when the contract is made; for purposes of § 301.6323(d)-1(a), a contract right is subject to the lien imposed by section 6321 if the contract has been made by the time of tax lien filing; and that, for purposes of § 301.6323(h)-1(a) (relating to the definition of a security interest) a contract right is in existence when the contract is made.

Section 301.6323(c)-1(d) of the proposed regulations has also been revised to reflect changes in local law. In the proposed regulations, § 301.6323(c)-1(d) provided that an account receivable is acquired by a taxpayer at the time, and to the extent, a right to payment is earned by performance. Because some jurisdictions have adopted a revised defini-

tion of an "account", the regulations have been revised to emphasize that the priority of a security interest over a Federal tax lien does not depend upon local law definitions of the various types of property interests comprising commercial financing security.

Section 301.6323(g)-1(b)(2)(ii) of the proposed regulations has been revised to extend a transitional date for sending change of address notices to the Internal Revenue Service. Under the proposed regulations, a change of address notice sent to any office of the Service would be effective, provided such notice was received prior to July 1, 1973. Section 301.6323(g)-1(b)(2)(ii) of the final regulations provides that such a notice sent to any office of the Service will be effective, provided that it is received prior to the date this Treasury decision is published in the Federal Register.

Adoption of amendments to the regulations

On January 4, 1973, a notice of proposed rule making was published in the Federal Register (38 F.R. 776) in order to conform the Income Tax Regulations, the Estate Tax Regulations, the Gift Tax Regulations and the Regulations on Procedure and Administration (26 CFR Parts 1, 20, 25, and 301) under sections 545, 6323, and 6325 of the Internal Revenue Code of 1954 to section 236 of the Revenue Act of 1964 (78 Stat. 127), section 17(a) of Public Law 89-493 (80 Stat. 263), and sections 101 and 103 of the Federal Tax Lien Act of 1966 (80 Stat. 1125 and 1133). Section 301.6323(g)-1 of the regulations hereby adopted supersedes §§ 400.1 and 400.1-1 of this chapter, relating to section 101(a) of the Federal Tax Lien Act of 1966, which were prescribed by T.D. 6932, approved October 13, 1967 (32 F.R. 14385) [1967-2 C.B. 637]. Section 301.6325-1 of the regulations hereby adopted supersedes §§ 400.2 and 400.2-1 of this chapter, relating to section 103(a) of such Act, which were prescribed by T.D. 6944, approved January 17, 1968 (33 F.R. 732) [1968-2 C.B. 854]. After taking into consideration all such relevant matter as was presented by interested persons regarding the rules proposed, the following amendments of the regulations are hereby adopted:

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. Paragraph (i)(1) of § 1.545-2 is amended to read as follows:

§ 1.545-2 Adjustments to taxable income.

* * * * *

(i) *Amount of a lien in favor of the United States.* (1) If notices of lien are filed in the manner provided in section 6323(f), the amount of the liability to the United States outstanding at the close of the taxable year, and secured by such liens which are in effect at that time, shall be allowed as a deduction in computing undistributed personal holding company income. However, the amount of such deduction which may be allowed for any taxable year shall not exceed the taxable income (as adjusted for purposes of determining the undistributed personal holding company income, but without regard to the deduction under section 545(b)(9)) for such year. The fact that the amount of, or any part of, the outstanding obligation to the United States was deducted for one taxable year does not prevent its deduction for a subsequent taxable year to the extent the obligation is still outstanding at the close of the taxable year and is secured by a lien, notice of which has been filed.

* * * * *

ESTATE TAX REGULATIONS (26 CFR Part 20)

Par. 2. Section 20.6323 is amended by revising subsections (a) through (e), by adding subsections (f) through (i), and by revising the historical note. These revised and added provisions read as follows:

§ 20.6323 Statutory provisions; validity and priority against certain persons.

Sec. 6323. *Validity and priority against certain persons*—(a) *Purchases, holders of security interests, mechanic's lienors, and judgment lien creditors.* The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary or his delegate.

(b) *Protection for certain interests even though notice filed.* Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid—

(1) *Securities.* With respect to a security (as defined in subsection (h)(4))—

(A) As against a purchaser of such security who at the time of purchase did not have actual notice or knowledge of the existence of such lien; and

(B) As against a holder of a security interest in such security who, at the time such interest came into existence, did not have actual notice or knowledge of the existence of such lien.

(2) *Motor vehicles.* With respect to a motor vehicle (as defined in subsection (h)(3)), as against a purchaser of such motor vehicle, if—

(A) At the time of the purchase such purchaser did not have actual notice or knowledge of the existence of such lien, and

(B) Before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent.

(3) *Personal property purchased at retail.* With respect to tangible personal property purchased at retail, as against a purchaser in the ordinary course of the seller's trade or business, unless at the time of such purchase such purchaser intends such purchase to (or knows such purchase will) hinder, evade, or defeat the collection of any tax under this title.

(4) *Personal property purchased in casual sale.* With respect to household goods, personal effects, or other tangible personal property described in section 6334(a) purchased (not for resale) in a casual sale for less than $250, as against the purchaser, but only if such purchaser does not have actual notice or knowledge (A) of the existence of such lien, or (B) that this sale is one of a series of sales.

(5) *Personal property subject to possessory lien.* With respect to tangible personal property subject to a lien under local law securing the reasonable price of the repair or improvement of such property, as against a holder of such a lien, if such holder is, and has been, continuously in

possession of such property from the time such lien arose.

(6) *Real property tax and special assessment liens.* With respect to real property, as against a holder of a lien upon such property, if such lien is entitled under local law to priority over security interests in such property which are prior in time, and such lien secures payment of—

(A) A tax of general application levied by any taxing authority based upon the value of such property;

(B) A special assessment imposed directly upon such property by any taxing authority, if such assessment is imposed for the purpose of defraying the cost of any public improvement; or

(C) Charges for utilities or public services furnished to such property by the United States, a State or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

(7) *Residential property subject to a mechanic's lien for certain repairs and improvements.* With respect to real property subject to a lien for repair or improvement of a personal residence (containing not more than four dwelling units) occupied by the owner of such residence, as against a mechanic's lienor, but only if the contract price on the contract with the owner is not more than $1,000.

(8) *Attorneys' liens.* With respect to a judgment or other amount in settlement of a claim or of a cause of action, as against an attorney who, under local law, holds a lien upon or contract enforcible against such judgment or amount, to the extent of his reasonable compensation for obtaining such judgment or procuring such settlement, except that this paragraph shall not apply to any judgment or amount in settlement of a claim or of a cause of action against the United States to the extent that the United States offsets such judgment or amount against any liability of the taxpayer to the United States.

(9) *Certain insurance contracts.* With respect to a life insurance, endowment, or annuity contract, as against the organization which is the insurer under such contract, at any time—

(A) Before such organization had actual notice or knowledge of the existence of such lien;

(B) After such organization had such notice or knowledge, with respect to advances required to be made automatically to maintain such contract in force under an agreement entered into before such organization had such notice or knowledge; or

(C) After satisfaction of a levy pursuant to section 6332(b), unless and until the Secretary or his delegate delivers to such organization a notice, executed after the date of such satisfaction, of the existence of such lien.

(10) *Passbook loans.* With respect to a savings deposit, share, or other account, evidenced by a passbook, with an institution described in section 581 or 591, to the extent of any loan made by such institution without actual notice or knowledge of the existence of such lien, as against such institution, if such loan is secured by such account and if such institution has been continuously in possession of such passbook from the time the loan is made.

(c) *Protection for certain commercial transactions financing agreements, etc.*—(1) *In general.* To the extent provided in this subsection, even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which—

(A) Is in qualified property covered by the terms of a written agreement entered into before tax lien filing and constituting—

(i) A commercial transactions financing agreement,

(ii) A real property construction or improvement financing agreement, or

(iii) An obligatory disbursement agreement, and

(B) Is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

(2) *Commercial transactions financing agreement.* For purposes of this subsection—

(A) *Definition.* The term "commercial transactions financing agreement" means an agreement (entered into by a person in the course of his trade or business)—

(i) To make loans to the taxpayer to be secured by commercial financing security acquired by the taxpayer in the ordinary course of his trade or business, or

(ii) To purchase commercial financing security (other than inventory) acquired by the taxpayer in the ordinary course of his trade or business; but such an agreement shall be treated as coming within the term only to the extent that such loan or purchase is made before the 46th day after the date of tax lien filing or (if earlier) before the lender or purchaser had actual notice or knowledge of such tax lien filing.

(B) *Limitation on qualified property.* The term "qualified property", when used with respect to a commercial transactions financing agreement, includes only commercial financing security acquired by the taxpayer before the 46th day after the date of tax lien filing.

(C) *Commercial financing security defined.* The term "commercial financing security" means (i) paper of a kind ordinarily arising in commercial transactions, (ii) accounts receivable, (iii) mortgages on real property, and (iv) inventory.

(D) *Purchaser treated as acquiring security interest.* A person who satisfies subparagraph (A) by reason of clause (ii) thereof shall be treated as having acquired a security interest in commercial financing security.

(3) *Real property construction or improvement financing agreement.* For purposes of this subsection—

(A) *Definition.* The term "real property construction or improvement financing agreement" means an agreement to make cash disbursements to finance—

(i) The construction or improvement of real property,

(ii) A contract to construct or improve real property, or

(iii) The raising or harvesting of a farm crop or the raising of livestock or other animals. For purposes of clause (iii), the furnishing of goods and services shall be treated as the disbursement of cash.

(B) *Limitation on qualified property.* The term "qualified property", when used with respect to a real property construction or improvement financing agreement, includes only—

(i) In the case of subparagraph (A)(i), the real property with respect to which the construction or improvement has been or is to be made,

(ii) In the case of subparagraph (A)(ii), the proceeds of the contract described therein, and

(iii) In the case of subparagraph (A)(iii), property subject to the lien imposed by section 6321 at the time of tax lien filing and the crop or the livestock or other animals referred to in subparagraph (A)(iii).

(4) *Obligatory disbursement agreement.* For purposes of this subsection—

(A) *Definition.* The term "obligatory disbursement agreement" means an agreement (entered into by a person in the course of his trade or business) to make disbursements, but such an agreement shall be treated as coming within the term only to the extent of disbursements which are required to be made by reason of the intervention of the rights of a person other than the taxpayer.

(B) *Limitation on qualified property.* The term "qualified property", when used with respect to an obligatory disbursement agreement, means property subject to the lien imposed by section 6321 at the time of tax lien filing and (to the extent that the acquisition is directly traceable to the disbursements referred to in subparagraph (A)) property acquired by the taxpayer after tax lien filing.

(C) *Special rules for surety agreements.* Where the obligatory disbursement agreement is an agreement ensuring the performance of a contract between the taxpayer and another person—

(i) The term "qualified property" shall be treated as also including the proceeds of the contract the performance of which was ensured, and

(ii) If the contract the performance of which was ensured was a contract to construct or improve real property, to produce goods, or to furnish services, the term "qualified property" shall be treated as also including any tangible personal property used by the taxpayer in the performance of such ensured contract.

(d) *45-day period for making disbursements.* Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing by reason of disburse-

ments made before the 46th day after the date of tax lien filing, or (if earlier) before the person making such disbursements had actual notice or knowledge of tax lien filing, but only if such security interest—

(1) Is in property (A) subject, at the time of tax lien filing, to the lien imposed by section 6321, and (B) covered by the terms of a written agreement entered into before tax lien filing, and

(2) Is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

(e) *Priority of interest and expenses.* If the lien imposed by section 6321 is not valid as against a lien or security interest, the priority of such lien or security interest shall extend to—

(1) Any interest or carrying charges upon the obligation secured,

(2) The reasonable charges and expenses of an indenture trustee or agent holding the security interest for the benefit of the holder of the security interest,

(3) The reasonable expenses, including reasonable compensation for attorneys, actually incurred in collecting or enforcing the obligation secured,

(4) The reasonable costs of insuring, preserving, or repairing the property to which the lien or security interest relates,

(5) The reasonable costs of insuring payment of the obligation secured, and

(6) Amounts paid to satisfy any lien on the property to which the lien or security interest relates, but only if the lien so satisfied is entitled to priority over the lien imposed by section 6321.

to the extent that, under local law, any such item has the same priority as the lien or security interest to which it relates.

(f) *Place for filing notice; form*—(1) *Place for filing.* The notice referred to in subsection (a) shall be filed—

(A) *Under state laws*—(i) *Real property.* In the case of real property, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated; and

(ii) *Personal property.* In the case of personal property, whether tangible or intangible, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated; or

(B) *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 has not by law designated one office which meets the requirements of subparagraph (A); or

(C) *With recorder of deeds of the District of Columbia.* In the office of the Recorder of Deeds of the District of Columbia, if the property subject to the lien is situated in the District of Columbia.

(2) *Situs of property subject to lien.* For purposes of paragraph (1), property shall be deemed to be situated—

(A) *Real property.* In the case of real property, at its physical location; or

(B) *Personal property.* In the case of personal property, whether tangible or intangible, at the residence of the taxpayer at the time the notice of lien is filed.

For purposes of paragraph (2)(B), the residence of a corporation or partnership shall be deemed to be the place at which the principal executive office of the business is located, and the residence of a taxpayer whose residence is without the United States shall be deemed to be in the District of Columbia.

(3) *Form.* The form and content of the notice referred to in subsection (a) shall be prescribed by the Secretary or his delegate. Such notice shall be valid notwithstanding any other provision of law regarding the form or content of a notice of lien.

(g) *Refiling of notice.* For purposes of this section—

(1) *General rule.* Unless notice of lien is refiled in the manner prescribed in paragraph (2) during the required refiling period, such notice of lien shall be treated as filed on the date on which it is filed (in accordance with subsection (f)) after the expiration of such refiling period.

(2) *Place for filing.* A notice of lien refiled during the required refiling period shall be effective only—

(A) If such notice of lien is refiled in the office in which the prior notice of lien was filed; and

(B) In any case in which, 90 days or more prior to the date of a refiling of notice of lien under subparagraph (A), the Secretary or his delegate received written information (in the manner prescribed in regulations issued by the Secretary or his delegate) concerning a change in the taxpayer's residence, if a notice of such lien is also filed in accordance with subsection (f) in the State in which such residence is located.

(3) *Required refiling period.* In the case of any notice of lien, the term "required refiling period" means—

(A) The one-year period ending 30 days after the expiration of 6 years after the date of the assessment of the tax, and

(B) The one-year period ending with the expiration of 6 years after the close of the preceding required refiling period for such notice of lien.

(4) *Transitional rule.* Notwithstanding paragraph (3), if the assessment of the tax was made before January 1, 1962, the first required refiling period shall be the calendar year 1967.

(h) *Definitions.* For purposes of this section and section 6324—

(1) *Security interest.* The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.

(2) *Mechanic's lienor.* The term "mechanic's lienor" means any person who under local law has a lien on real property (or on the proceeds of a contract relating to real property) for services, labor, or materials furnished in connection with the construction or improvement of such property. For purposes of the preceding sentence, a person has a lien on the earliest date such lien becomes valid under local law against subsequent purchasers without actual notice, but not before he begins to furnish the services, labor, or materials.

(3) *Motor vehicle.* The term "motor vehicle" means a self-propelled vehicle which is registered for highway use under the laws of any State or foreign country.

(4) *Security.* The term "security" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form, share of stock, voting trust certificate, or any certificate of interest or participation in, certificate of deposit or receipt for, temporary or interim certificate, for or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

(5) *Tax lien filing.* The term "tax lien filing" means the filing of notice (referred to in subsection (a)) of the lien imposed by section 6321.

(6) *Purchaser.* The term "purchaser" means a person who, for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice. In applying the preceding sentence for purposes of subsection (a) of this section, and for purposes of section 6324—

(A) A lease of property,

(B) A written executory contract to purchase or lease property.

(C) An option to purchase or lease property or any interest therein, or

(D) An option to renew or extend a lease of property, which is not a lien or security interest shall be treated as an interest in property.

(i) *Special rules*—(1) *Actual notice or knowledge.* For purposes of this subchapter, an organization shall be deemed for purposes of a particular transaction to have actual notice or knowledge of any fact from the time such fact is brought to the attention of the individual conducting such transaction, and in any event from the time such fact would have been brought to such individual's attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person

conducting the transaction and there is reasonable compliance with the routine. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

(2) *Subrogation.* Where, under local law, one person is subrogated to the rights of another with respect to a lien or interest, such person shall be subrogated to such rights for purposes of any lien imposed by section 6321 or 6324.

(3) *Disclosure of amount of outstanding lien.* If a notice of lien has been filed pursuant to subsection (f), the Secretary or his delegate is authorized to provide by regulations the extent to which, and the conditions under which, information as to the amount of the outstanding obligation secured by the lien may be disclosed.

[Sec. 6323 as amended by sec. 236(a) and (c)(1), Rev. Act 1964 (78 Stat. 127) [Pub. L. 88-272, 1964-1 (Part 2) C.B. 6]; sec. 17(a), Act of July 5, 1966 (Pub. Law 89-493, 80 Stat. 263) [1966-2 C.B. 594]; sec. 101(a), Federal Tax Lien Act 1966 (80 Stat. 1125) [Pub. L. 89-719, 1966-2 C.B. 623]]

Par. 3. Section 20.6323-1 is amended to read as follows:

§ 20.6323-1 Validity and priority against certain persons.

For regulations concerning the validity of the lien imposed by section 6321 against certain persons, see §§ 301.6323(a)-1 through 301.6323(i)-1 of this chapter (Regulations on Procedure and Administration).

Par. 4. Section 20.6325 is amended by revising subsections (a) through (e), by adding subsections (f) through (h), and by revising the historical note. These revised and added provisions read as follows:

§ 20.6325 Statutory provisions; release of lien or discharge of property.

Sec. 6325. *Release of lien or discharge of property*—(a) *Release of lien.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of release of any lien imposed with respect to any internal revenue tax if—

(1) *Liability satisfied or unenforceable.* The Secretary or his delegate finds that the liability for the amount assessed, together with all interest in respect thereof, has been fully satisfied or has become legally unenforceable; or

(2) *Bond accepted.* There is furnished to the Secretary or his delegate and accepted by him a bond that is conditioned upon the payment of the amount assessed, together with all interest in respect thereof, within the time prescribed by law (including any extension of such time), and that is in accordance with such requirements relating to terms, conditions, and form of the bond and sureties thereon, as may be specified by such regulations.

(b) *Discharge of property*—(1) *Property double the amount of the liability.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of discharge of any part of the property subject to any lien imposed under this chapter if the Secretary or his delegate finds that the fair market value of that part of such property remaining subject to the lien is at least double the amount of the unsatisfied liability secured by such lien and the amount of all other liens upon such property which have priority over such lien.

(2) *Part payment; interest of United States valueless.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of discharge of any part of the property subject to the lien if—

(A) There is paid over to the Secretary or his delegate in partial satisfaction of the liability secured by the lien an amount determined by the Secretary or his delegate, which shall not be less than the value, as determined by the Secretary or his delegate, of the interest of the United States in the part to be so discharged, or

(B) The Secretary or his delegate determines at any time that the interest of the United States in the part to be so discharged has no value.

In determining the value of the interest of the United States in the part to be so discharged, the Secretary or his delegate shall give consideration to the value of such part and to such liens thereon as have priority over the lien of the United States.

(3) *Substitution of proceeds of sale.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of discharge of any part of the property subject to the lien if such part of the property is sold and, pursuant to an agreement with the Secretary or his delegate, the proceeds of such sale are to be held, as a fund subject to the liens and claims of the United States, in the same manner and with the same priority as such liens and claims had with respect to the discharged property.

(c) *Estate or gift tax.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of discharge of any or all of the property subject to any lien imposed by section 6324 if the Secretary or his delegate finds that the liability secured by such lien has been fully satisfied or provided for.

(d) *Subordination of lien.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of subordination of any lien imposed by this chapter upon any part of the property subject to such lien if—

(1) There is paid over to the Secretary or his delegate an amount equal to the amount of the lien or interest to which the certificate subordinates the lien of the United States, or

(2) The Secretary or his delegate believes that the amount realizable by the United States from the property to which the certificate relates, or from any other property subject to the lien, will ultimately be increased by reason of the issuance of such certificate and that the ultimate collection of the tax liability will be facilitated by such subordination.

(e) *Nonattachment of lien.* If the Secretary or his delegate determines that, because of confusion of names or otherwise, any person (other than the person against whom the tax was assessed) is or may be injured by the appearance that a notice of lien filed under section 6323 refers to such person, the Secretary or his delegate may issue a certificate that the lien does not attach to the property of such person.

(f) *Effect of certificate*—(1) *Conclusiveness.* Except as provided in paragraphs (2) and (3), if a certificate is issued pursuant to this section by the Secretary or his delegate and is filed in the same office as the notice of lien to which it relates (if such notice of lien has been filed) such certificate shall have the following effect:

(A) In the case of a certificate of release, such certificate shall be conclusive that the lien referred to in such certificate is extinguished;

(B) In the case of a certificate of discharge, such certificate shall be conclusive that the property covered by such certificate is discharged from the lien;

(C) In the case of a certificate of subordination, such certificate shall be conclusive that the lien or interest to which the lien of the United States is subordinated is superior to the lien of the United States; and

(D) In the case of a certificate of nonattachment, such certificate shall be conclusive that the lien of the United States does not attach to the property of the person referred to in such certificate.

(2) *Revocation of certificate of release or nonattachment.* If the Secretary or his delegate determines that a certificate of release or nonattachment of a lien imposed by section 6321 was issued erroneously or improvidently, or if a certificate of release of such lien was issued pursuant to a collateral agreement entered into in connection with a compromise under section 7122 which has been breached, and if the period of limitation on collection

after assessment has not expired, the Secretary or his delegate may revoke such certificate and reinstate the lien—

(A) By mailing notice of such revocation to the person against whom the tax was assessed at his last known address, and

(B) By filing notice of such revocation in the same office in which the notice of lien to which it relates was filed (if such notice of lien had been filed).

Such reinstated lien (i) shall be effective on the date notice of revocation is mailed to the taxpayer in accordance with the provisions of subparagraph (A), but not earlier than the date on which any required filing of notice of revocation is filed in accordance with the provisions of subparagraph (B), and (ii) shall have the same force and effect (as of such date), until the expiration of the period of limitation on collection after assessment, as a lien imposed by section 6321 (relating to lien for taxes).

(3) *Certificates void under certain conditions.* Notwithstanding any other provision of this subtitle, any lien imposed by this chapter shall attach to any property with respect to which a certificate of discharge has been issued if the person liable for the tax reacquires such property after such certificate has been issued.

(g) *Filing of certificates and notices.* If a certificate or notice issued pursuant to this section may not be filed in the office designated by State law in which the notice of lien imposed by section 6321 is filed, such certificate or notice shall be effective if filed in the office of the clerk of the United States district court for the judicial district in which such office is situated.

(h) *Cross reference.* For provisions relating to bonds, see chapter 73 (sec. 7101 and following).

[Sec. 6325 as amended by sec. 77, Technical Amendments Act 1958 (72 Stat. 1662) [Pub. L. 85-866, 1958-3 C.B. 254]; sec. 103, Federal Tax Lien Act 1966 (80 Stat. 1133)]

GIFT TAX REGULATIONS
(26 CFR Part 25)

Par. 5. Section 25.6323 is amended by revising subsections (a) through (e), by adding subsections (f) through (i), and by revising the historical note. These revised and amended provisions read as follows:

§ 25.6323 Statutory provisions; validity and priority against certain persons.

Sec. 6323. *Validity and priority against certain persons*—(a) *Purchases, holders of security interests, mechanic's lienors, and judgment lien creditors.* The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary or his delegate.

(b) *Protection for certain interests even though notice filed.* Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid—

(1) *Securities.* With respect to a security (as defined in subsection (h)(4))—

(A) As against a purchaser of such security who at the time of purchase did not have actual notice or knowledge of the existence of such lien; and

(B) As against a holder of a security interest in such security who, at the time such interest came into existence, did not have actual notice or knowledge of the existence of such lien.

(2) *Motor vehicles.* With respect to a motor vehicle (as defined in subsection (h)(3)), as against a purchaser of such motor vehicle, if—

(A) At the time of the purchase such purchaser did not have actual notice or knowledge of the existence of such lien, and

(B) Before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent.

(3) *Personal property purchased at retail.* With respect to tangible personal property purchased at retail, as against a purchaser in the ordinary course of the seller's trade or business, unless at the time of such purchase such purchaser intends such purchase to (or knows such purchase will) hinder, evade, or defeat the collection of any tax under this title.

(4) *Personal property purchased in casual sale.* With respect to household goods, personal effects, or other tangible personal property described in section 6334 (a) purchased (not for resale) in a casual sale for less than $250, as against the purchaser, but only if such purchaser does not have actual notice or knowledge (A) of the existence of such lien, or (B) that this sale is one of a series of sales.

(5) *Personal property subject to possessory lien.* With respect to tangible personal property subject to a lien under local law securing the reasonable price of the repair or improvement of such property, as against a holder of such a lien, if such holder is, and has been, continuously in possession of such property from the time such lien arose.

(6) *Real property tax and special assessment liens.* With respect to real property, as against a holder of a lien upon such property, if such lien is entitled under local law to priority over security interests in such property which are prior in time, and such lien secures payment of—

(A) A tax of general application levied by any taxing authority based upon the value of such property;

(B) A special assessment imposed directly upon such property by any taxing authority, if such assessment is imposed for the purpose of defraying the cost of any public improvement; or

(C) Charges for utilities or public services furnished to such property by the United States, a State or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

(7) *Residential property subject to a mechanic's lien for certain repairs and improvements.* With respect to real property subject to a lien for repair or improvement of a personal residence (containing not more than four dwelling units) occupied by the owner of such residence, as against a mechanic's lienor, but only if the contract price on the contract with the owner is not more than $1,000.

(8) *Attorneys' liens.* With respect to a judgment or other amount in settlement of a claim or of a cause of action, as against an attorney who, under local law, holds a lien upon or a contract enforcible against such judgment or amount, to the extent of his reasonable compensation for obtaining such judgment or procuring such settlement, except that this paragraph shall not apply to any judgment or amount in settlement of a claim or of a cause of action against the United States to the extent that the United States offsets such judgment or amount against any liability of the taxpayer to the United States.

(9) *Certain insurance contracts.* With respect to a life insurance, endowment, or annuity contract, as against the organization which is the insurer under such contract, at any time—

(A) Before such organization had actual notice or knowledge of the existence of such lien;

(B) After such organization had such notice or knowledge, with respect to advances required to be made automatically to maintain such contract in force under an agreement entered into before such organization had such notice or knowledge; or

(C) After satisfaction of a levy pursuant to section 6332(b), unless and until the Secretary or his delegate delivers to such organization a notice, executed after the date of such satisfaction, of the existence of such lien.

(10) *Passbook loans.* With respect to a savings deposit, share, or other account, evidenced by a passbook, with an institution described in section 581 or 591, to the extent of any loan made by such institution without actual notice or knowledge of the existence of such lien, as against such institution, if such loan is secured by such account and if such institution has been continuously in possession of such passbook from the time the loan is made.

(c) *Protection for certain commercial transactions financing agreements, etc.*—(1) *In general.* To the extent provided in this subsection, even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which—

(A) Is in qualified property covered by the terms of a written agreement en-

tered into before tax lien filing and constituting—

(i) A commercial transactions financing agreement,

(ii) A real property construction or improvement financing agreement, or

(iii) An obligatory disbursement agreement, and

(B) Is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

(2) *Commercial transactions financing agreement.* For purposes of this subsection—

(A) *Definition.* The term "commercial transactions financing agreement" means an agreement (entered into by a person in the course of his trade or business)—

(i) To make loans to the taxpayer to be secured by commercial financing security acquired by the taxpayer in the ordinary course of his trade or business, or

(ii) To purchase commercial financing security (other than inventory) acquired by the taxpayer in the ordinary course of his trade or business; but such an agreement shall be treated as coming within the term only to the extent that such loan or purchase is made before the 46th day after the date of tax lien filing or (if earlier) before the lender or purchaser had actual notice or knowledge of such tax lien filing.

(B) *Limitation on qualified property.* The term "qualified property", when used with respect to a commercial transactions financing agreement, includes only commercial financing security acquired by the taxpayer before the 46th day after the date of tax lien filing.

(C) *Commercial financing security defined.* The term "commercial financing security" means (i) paper of a kind ordinarily arising in commercial transactions, (ii) accounts receivable, (iii) mortgages on real property, and (iv) inventory.

(D) *Purchaser treated as acquiring security interest.* A person who satisfies subparagraph (A) by reason of clause (ii) thereof shall be treated as having acquired a security interest in commercial financing security.

(3) *Real property construction or improvement financing agreement.* For purposes of this subsection—

(A) *Definition.* The term "real property construction or improvement financing agreement" means an agreement to make cash disbursements to finance—

(i) The construction or improvement of real property,

(ii) A contract to construct or improve real property, or

(iii) The raising or harvesting of a farm crop or the raising of livestock or other animals.

For purposes of clause (iii), the furnishing of goods and services shall be treated as the disbursement of cash.

(B) *Limitation on qualified property.* The term "qualified property", when used with respect to a real property construction or improvement financing agreement, includes only—

(i) In the case of subparagraph (A)(i), the real property with respect to which the construction or improvement has been or is to be made,

(ii) In the case of subparagraph (A)(ii), the proceeds of the contract described therein, and

(iii) In the case of subparagraph (A)(iii), property subject to the lien imposed by section 6321 at the time of tax lien filing and the crop or the livestock or other animals referred to in subparagraph (A)(iii).

(4) *Obligatory disbursement agreement.* For purposes of this subsection—

(A) *Definition.* The term "obligatory disbursement agreement" means an agreement (entered into by a person in the course of his trade or business) to make disbursements, but such an agreement shall be treated as coming within the term only to the extent of disbursements which are required to be made by reason of the intervention of the rights of a person other than the taxpayer.

(B) *Limitation on qualified property.* The term "qualified property", when used with respect to an obligatory disbursement agreement, means property subject to the lien imposed by section 6321 at the time of tax lien filing and (to the extent that the acquisition is directly traceable to the disbursements referred to in subparagraph (A)) property acquired by the taxpayer after tax lien filing.

(C) *Special rules for surety agreements.* Where the obligatory disbursement agreement is an agreement ensuring the performance of a contract between the taxpayer and another person—

(i) The term "qualified property" shall be treated as also including the proceeds of the contract the performance of which was ensured, and

(ii) If the contract the performance of which was ensured was a contract to construct or improve real property, to produce goods, or to furnish services, the term "qualified property" shall be treated as also including any tangible personal property used by the taxpayer in the performance of such ensured contract.

(d) 45-day period for making disbursements. Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing by reason of disbursements made before the 46th day after the date of tax lien filing, or (if earlier) before the person making such disbursements had actual notice or knowledge of tax lien filing, but only if such security interest—

(1) Is in property (A) subject, at the time of tax lien filing, to the lien imposed by section 6321, and (B) covered by the terms of a written agreement entered into before tax lien filing, and

(2) Is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

(e) *Priority of interest and expenses.* If the lien imposed by section 6321 is not valid as against a lien or security interest, the priority of such lien or security interest shall extend to—

(1) Any interest or carrying charges upon the obligation secured,

(2) The reasonable charges and expenses of an indenture trustee or agent holding the security interest for the benefit of the holder of the security interest,

(3) The reasonable expenses, including reasonable compensation for attorneys, actually incurred in collecting or enforcing the obligation secured,

(4) The reasonable costs of insuring, preserving, or repairing the property to which the lien or security interest relates,

(5) The reasonable costs of insuring payment of the obligation secured, and

(6) Amounts paid to satisfy any lien on the property to which the lien or security interest relates, but only if the lien so satisfied is entitled to prority over the lien imposed by section 6321, to the extent that, under local law, any such item has the same priority as the lien or security interest to which it relates.

(f) *Place for filing notice; form*—(1) *Place for filing.* The notice referred to in subsection (a) shall be filed—

(A) *Under state laws*—(i) *Real property.* In the case of real property, in one office within the State (or the county, of other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated; and

(ii) *Personal property.* In the case of personal property, whether tangible or intangible, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated; or

(B) *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 has not by law designated one office which meets the requirements of subparagraph (A); or

(C) *With recorder of deeds of the District of Columbia.* In the office of the Recorder of Deeds of the District of Columbia, if the property subject to the lien is situated in the District of Columbia.

(2) *Situs of property subject to lien.* For purposes of paragraph (1), property shall be deemed to be situated—

(A) *Real property.* In the case of real property, at its physical location; or

(B) *Personal property.* In the case of personal property, whether tangible or intangible, at the residence of the taxpayer at the time the notice of lien is filed.

For purposes of paragraph (2)(B), the residence of a corporation or partnership shall be deemed to be the place at which the principal executive office of the busi-

ness is located, and the residence of a taxpayer whose residence is without the United States shall be deemed to be in the District of Columbia.

(3) *Form.* The form and content of the notice referred to in subsection (a) shall be prescribed by the Secretary or his delegate. Such notice shall be valid notwithstanding any other provision of law regarding the form or content of a notice of lien.

(g) *Refiling of notice.* For purposes of this section—

(1) *General rule.* Unless notice of lien is refiled in the manner prescribed in paragraph (2) during the required refiling period, such notice of lien shall be treated as filed on the date on which it is filed (in accordance with subsection (f) after the expiration of such refiling period.

(2) *Place for filing.* A notice of lien refiled during the required refiling period shall be effective only—

(A) If such notice of lien is refiled in the office in which the prior notice of lien was filed; and

(B) In any case in which, 90 days or more prior to the date of a refiling of notice of lien under subparagraph (A), the Secretary or his delegate received written information (in the manner prescribed in regulations issued by the Secretary or his delegate) concerning a change in the taxpayer's residence, if a notice of such lien is also filed in accordance with subsection (f) in the State in which such residence is located.

(3) *Required refiling period.* In the case of any notice of lien, the term "required refiling period" means—

(A) The one-year period ending 30 days after the expiration of 6 years after the date of the assessment of the tax, and

(B) The one-year period ending with the expiration of 6 years after the close of the preceding required refiling period for such notice of lien.

(4) *Transitional rule.* Notwithstanding paragraph (3), if the assessment of the tax was made before January 1, 1962, the first required refiling period shall be the calendar year 1967.

(h) *Definitions.* For purposes of this section and section 6324—

(1) *Security interest.* The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.

(2) *Mechanic's lienor.* The term "mechanic's lienor" means any person who under local law has a lien on real property (or on the proceeds of a contract relating to real property) for services, labor, or materials furnished in connection with the construction or improvement of such property. For purposes of the preceding sentence, a person has a lien on the earliest date such lien becomes valid under local law against subsequent purchasers without actual notice, but not before he begins to furnish the services, labor, or materials.

(3) *Motor vehicle.* The term "motor vehicle" means a self-propelled vehicle which is registered for highway use under the laws of any State or foreign country.

(4) *Security.* The term "security" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form, share of stock, voting trust certificate, or any certificate of interest or participation in, certificate of deposit or receipt for, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

(5) *Tax lien filing.* The term "tax lien filing" means the filing of notice (referred to in subsection (a)) of the lien imposed by section 6321.

(6) *Purchaser.* The term "purchaser" means a person who, for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice. In applying the preceding sentence for purposes of subsection (a) of this section, and for purposes of section 6324—

(A) A lease of property,

(B) A written executory contract to purchase or lease property,

(C) An option to purchase or lease property or any interest therein, or

(D) An option to renew or extend a lease of property,

which is not a lien or security interest shall be treated as an interest in property.

(i) *Special rules*—(1) *Actual notice or knowledge.* For purposes of this subchapter, an organization shall be deemed for purposes of a particular transaction to have actual notice or knowledge of any fact from the time such fact is brought to the attention of the individual conducting such transaction, and in any event from the time such fact would have been brought to such individual's attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routine. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

(2) *Subrogation.* Where, under local law, one person is subrogated to the rights of another with respect to a lien or interest, such person shall be subrogated to such rights for purposes of any lien imposed by section 6321 or 6324.

(3) *Disclosure of amount of outstanding lien.* If a notice of lien has been filed pursuant to subsection (f), the Secretary or his delegate is authorized to provide by regulations the extent to which, and the conditions under which, information as to the amount of the outstanding obligation secured by the lien may be disclosed.

[Sec. 6323 as amended by sec. 236(a) and (c)(1), Rev. Act 1964 (78 Stat. 127) [Pub. L. 88-272, 1964-1 (Part 2) C.B. 6]; sec. 17(a), Act of July 5, 1966 (Pub. Law 89-493, 80 Stat. 263) [1966-2 C.B. 594]; sec. 101(a), Federal Tax Lien Act 1966 (80 Stat. 1125] [Pub. L. 89-719, 1966-2 C.B. 623]]

Par. 6. Section 25.6323-1 is amended to read as follows:

§ 25.6323-1 Validity and priority against certain persons.

For regulations concerning the validity of the lien imposed by section 6321 against certain persons, see §§ 301.6323(a)-1 through 301.6323(i)-1 of this chapter (Regulations on Procedure and Administration).

REGULATIONS ON PROCEDURE AND ADMINISTRATION (26 CFR PART 301)

Par. 7. Sections 301.6323 and 301.6323-1 are deleted, and immediately following § 301.6322, there are added the following new sections:

§ 301.6323(a) Statutory provisions; validity and priority against certain persons; purchases, holders of security interests, mechanic's lienors, judgment lien creditors.

Sec. 6323. *Validity and priority against certain persons*—(a) *Purchases, holders of security interests, mechanic's lienors, and judgment lien creditors.* The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary or his delegate.

[Sec. 6323(a) as amended by sec. 236(c)(1), Rev. Act 1964 (78 Stat. 127); sec. 17(a), Act of July 5, 1966 (Pub. Law 89-493, 80 Stat. 263); sec. 101(), Federal Tax Lien Act 1966 (80 Stat. 1125)]

§ 301.6323(a)-1 Purchasers, holders

of security interests, mechanic's lienors, and judgment lien creditors.

(a) *Invalidity of lien without notice.* The lien imposed by section 6321 is not valid against any purchaser (as defined in paragraph (f) of § 301.6323(h)-1), holder of a security interest (as defined in paragraph (a) of § 301.6323(h)-1), mechanic's lienor (as defined in paragraph (b) of § 301.6323(h)-1), or judgment lien creditor (as defined in paragraph (g) of § 301.6323(h)-1) until a notice of lien is filed in accordance with § 301.6323(f)-1. Except as provided by section 6323, if a person becomes a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor after a notice of lien is filed in accordance with § 301.6323(f)-1, the interest acquired by such person is subject to the lien imposed by section 6321.

(b) *Cross references.* For provisions relating to the protection afforded a security interest arising after tax lien filing, which interest is covered by a commercial transactions financing agreement, real property construction or improvement financing agreement, or an obligatory disbursement agreement, see §§ 301.6323(c)-1, 301.6323(c)-2, and 301.6323(c)-3, respectively. For provisions relating to the protection afforded to a security interest coming into existence by virtue of disbursements made before the 46th day after the date of tax lien filing, see § 301.6323(d)-1. For provisions relating to priority afforded to interest and certain other expenses with respect to a lien or security interest having priority over the lien imposed by section 6321, see §301.6323(e)-1. For provisions relating to certain other interests arising after tax lien filing, see § 301.6323(b)-1.

§ 301.6323(b) Statutory provisions; validity and priority against certain persons; protection for certain interests even though notice filed.

Sec. 6323. *Validity and priority against certain persons.* * * *

(b) *Protection for certain interests even though notice filed.* Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid—

(1) *Securities.* With respect to a security (as defined in subsection (h)(4))—

(A) As against a purchaser of such security who at the time of purchase did not have actual notice or knowledge of the existence of such lien; and

(B) As against a holder of a security interest in such security who, at the time such interest came into existence, did not have actual notice or knowledge of the existence of such lien.

(2) *Motor vehicles.* With respect to a motor vehicle (as defined in subsection (h)(3)), as against a purchaser of such motor vehicle, if—

(A) At the time of the purchase such purchaser did not have actual notice or knowledge of the existence of such lien, and

(B) Before the purchaser obtains such notice or knowledge, he has acquired possession of such motor vehicle and has not thereafter relinquished possession of such motor vehicle to the seller or his agent.

(3) *Personal property purchased at retail.* With respect to tangible personal property purchased at retail, as against a purchaser in the ordinary course of the seller's trade or business, unless at the time of such purchase such purchaser intends such purchase to (or knows such purchase will) hinder, evade, or defeat the collection of any tax under this title.

(4) *Personal property purchased in casual sale.* With respect to household goods, personal effects, or other tangible personal property described in section 6334(a) purchased (not for resale) in a casual sale for less than $250, as against the purchaser, but only if such purchaser does not have actual notice or knowledge (A) of the existence of such lien, or (B) that this sale is one of a series of sales.

(5) *Personal property subject to possessory lien.* With respect to tangible personal property subject to a lien under local law securing the reasonable price of the repair or improvement of such property, as against a holder of such a lien, if such holder is, and has been, continuously in possession of such property from the time such lien arose.

(6) *Real property tax and special assessment liens.* With respect to real property, as against a holder of a lien upon such property, if such lien is entitled under local law to priority over security interests in such property which are prior in time, and such lien secures payment of—

(A) A tax of general application levied by any taxing authority based upon the value of such property;

(B) A special assessment imposed directly upon such property by any taxing authority, if such assessment is imposed for the purpose of defraying the cost of any public improvement; or

(C) Charges for utilities or public services furnished to such property by the United States, a State or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

(7) *Residential property subject to a mechanic's lien for certain repairs and improvements.* With respect to real property subject to a lien for repair or improvement of a personal residence (containing not more than four dwelling units) occupied by the owner of such residence, as against a mechanic's lienor, but only if the contract price on the contract with the owner is not more than $1,000.

(8) *Attorneys' liens.* With respect to a judgment or other amount in settlement of a claim or of a cause of action, as against an attorney who, under local law, holds a lien upon or a contract enforcible against such judgment or amount, to the extent of his reasonable compensation for obtaining such judgment or procuring such settlement, except that this paragraph shall not apply to any judgment or amount in settlement of a claim or of a cause of action against the United States to the extent that the United States offsets such judgment or amount against any liability of the taxpayer to the United States.

(9) *Certain insurance contracts.* With respect to a life insurance, endowment, or annuity contract, as against the organization which is the insurer under such contract, at any time—

(A) Before such organization had actual notice or knowledge of the existence of such lien;

(B) After such organization had such notice or knowledge, with respect to advances required to be made automatically to maintain such contract in force under an agreement entered into before such organization had such notice or knowledge; or

(C) After satisfaction of a levy pursuant to section 6332(b), unless and until the Secretary or his delegate delivers to such organization a notice, executed after the date of such satisfaction, of the existence of such lien.

(10) *Passbook loans.* With respect to a savings deposit, share, or other account, evidenced by a passbook, with an institution described in section 581 or 591, to the extent of any loan made by such institution without actual notice or knowledge of the existence of such lien, as against such institution, if such loan is secured by such account and if such institution has been continuously in possession of such passbook from the time the loan is made.

[Sec. 6323(b) as amended by sec. 101(a), Federal Tax Lien Act 1966 (80 Stat. 1125) [Pub. L. 89-719, 1966-2 C.B. 623]]

§301.6323(b)-1 Protection for certain interests even though notice filed.

(a) *Securities*—(1) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid with respect to a security (as defined in paragraph (d) of § 301.6323(h)-1) against—

(i) A purchaser (as defined in paragraph (f) of § 301.6323(h)-1) of the security who at the time of purchase did not have actual notice or knowledge (as defined in paragraph (a) of § 301.6323(i)-1) of the existence of the lien;

(ii) A holder of a security interest (as defined in paragraph (a) of § 301.6323(h)-1) in the security who did not have actual notice or knowledge (as defined in paragraph (a) of § 301.6323(i)-1) of the existence of the lien at the time the security interest came into existence or at the time such security interest was acquired from a previous holder for a consideration in money or money's worth; or

(iii) A transferee of an interest protected under subdivision (i) or (ii) of this subparagraph to the same extent the lien is invalid against his transferor.

For purposes of subdivision (iii) of this subparagraph, no person can improve his position with respect to the lien by reacquiring the interest from an intervening purchaser or holder of a security interest against whom the lien is invalid.

(2) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). On May 1, 1969, in accordance with §301.6323(f)-1, a notice of lien is filed with respect to A's delinquent tax liability. On May 20, 1969, A sells 100 shares of common stock in X Corporation to B, who, on the date of the sale, does not have actual notice or knowledge of the existence of the lien. Because B purchased the stock without actual notice or knowledge of the lien, under subdivision (i) of subparagraph (1) of this paragraph, the stock purchased by B is not subject to the lien.

Example (2). Assume the same facts as in example (1) except that on May 30, 1969, B sells the 100 shares of common stock in X Corporation to C who on May 5, 1969, had actual notice of the existence of the tax lien against A. Because the X stock when purchased by B was not subject to the lien, under subdivision (iii) of subparagraph (1) of this paragraph, the stock purchased by C is not subject to the lien. C succeeds to B's rights, even though C had actual notice of the lien before B's purchase.

Example (3). On June 1, 1970, in accordance with §301.6323(f)-1, a notice of lien is filed with respect to D's delinquent tax liability. D owns twenty $1,000 bonds issued by the Y Company. On June 10, 1970, D obtains a loan from M Bank for $5,000 using the Y Company bonds as collateral. At the time the loan is made M Bank does not have actual notice or knowledge of the existence of the tax lien. Because M Bank did not have actual notice or knowledge of the lien when the security interest came into existence, under subdivision (ii) of subparagraph (1) of this paragraph, the tax lien is not valid against M Bank to the extent of its security interest.

Example (4). Assume the same facts as in example (3) except that on June 19, 1970, M Bank assigns the chose in action and its security interest to N, who had actual notice or knowledge of the existence of the lien on June 1, 1970. Because the security interest was not subject to the lien to the extent of M Bank's security interest, the security interest held by N is to the same extent entitled to priority over the tax lien because N succeeds to M Bank's rights. See subdivision (iii) of subparagraph (1) of this paragraph.

Example (5). On July 1, 1970, in accordance with §301.6323(f)-1, a notice of lien is filed with respect to E's delinquent tax liability. E owns ten $1,000 bonds issued by the Y Company. On July 5, 1970, E borrows $4,000 from F and delivers the bonds to F as collateral for the loan. At the time the loan is made, F has actual knowledge of the existence of the tax lien and, therefore, holds the security interest subject to the lien on the bonds. On July 10, 1970, F sells the security interest to G for $4,000 and delivers the Y Company bonds pledged as collateral. G does not have actual notice or knowledge of the existence of the lien on July 10, 1970. Because G did not have actual notice or knowledge of the lien at the time he purchased the security interest, under subdivision (ii) of subparagraph (1) of this paragraph, the tax lien is not valid against G to the extent of his security interest.

Example (6). Assume the same facts as in example (5) except that, instead of purchasing the security interest from F on July 10, 1970, G lends $4,000 to F and takes a security interest in F's security interest in the bonds on that date. Because G became the holder of a security interest in a security interest after notice of lien was filed and does not directly have a security interest in a security, the security interest held by G is not entitled to a priority over the tax lien under the provisions of subparagraph (1) of this paragraph.

(b) *Motor vehicles*—(1) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid against a purchaser (as defined in paragraph (f) of § 301.6323(h)-1) of a motor vehicle (as defined in paragraph (c) of § 301.6323(h)-1) if—

(i) At the time of the purchase, the purchaser did not have actual notice or knowledge (as defined in paragraph (a) of §301.6323(i)-1) of the existence of the lien, and

(ii) Before the purchaser obtains such notice or knowledge, he has acquired actual possession of the motor vehicle and has not thereafter relinquished actual possession to the seller or his agent.

(2) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). A, a delinquent taxpayer against whom a notice of tax lien has been filed in accordance with §301.6323(f)-1, sells his automobile (which qualifies as a motor vehicle under paragraph (c) of § 301.6323(h)-1) to B, an automobile dealer. B takes actual possession of the automobile and does not thereafter relinquish actual possession to the seller or his agent. Subsequent to his purchase, B learns of the existence of the tax lien against A. Even though notice of lien was filed before the purchase, the lien is not valid against B, because B did not know of the existence of the lien before the purchase and before acquiring actual possession of the vehicle.

Example (2). C is a wholesaler of used automobiles. A notice of lien has been filed with respect to C's delinquent tax liability in accordance with §301.6323(f)-1. Subsequent to such filing, D, a used automobile dealer, purchases and takes actual possession of twenty automobiles (which qualify as motor vehicles under the provisions of paragraph (c) of §301.6323(h)-1) from C at an auction and places them on his lot for sale. C does not reacquire possession of any of the automobiles. At the time of his purchase, D does not have actual notice or knowledge of the existence of the lien against C. Even though notice of lien was filed before D's purchase, the lien was not valid against D because D did not know of the existence of the lien before the purchase and before acquiring actual possession of the vehicles.

(3) *Cross reference.* For provisions relating to additional circumstances in which the lien imposed by section 6321 may not be valid against the purchaser of tangible personal property (including a motor vehicle) purchased at retail, see paragraph (c) of this section.

(c) *Personal property purchased at retail*—(1) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid against a purchaser (as defined in paragraph (f) of § 301.6323(h)-1) of tangible personal property purchased at a retail sale (as defined in subparagraph (2) of this paragraph) unless at the time of purchase the purchaser intends the purchase to (or knows that the purchase will) hinder, evade, or defeat the collection of any tax imposed by the Internal Revenue Code of 1954.

(2) *Definition of retail sale.* For purposes of this paragraph, the term "retail sale" means a sale, made in the ordinary course of the seller's trade or business, of tangible personal property of which the seller is the owner. Such term includes a sale in customary retail quantities by a seller who is going out of business, but does not include a bulk sale or an auction sale in which goods are offered in quantities substantially greater than are customary in the ordinary course of the seller's trade or business or an auction sale of goods the owner of which is not in the business of selling such goods.

(3) *Example.* The application of this paragraph may be illustrated by the following example:

Example. A purchases a refrigerator from the M Company, a retail appliance dealer. Prior to such purchase, a notice of lien was filed with respect to M's delinquent tax liability in accordance with §301.6323(f)-1. At the time of the purchase A knows of the existence of the lien. However, A does not intend the purchase to hinder, evade, or defeat the collection of any Internal Revenue tax, and A does not have any reason to believe that the purchase will affect the collection of any Internal Revenue tax. Even though notice of lien was filed before the purchase, the lien is not valid against A because A in good faith purchased the refrigerator at retail in the ordinary course of the M Company's business.

(d) *Personal property purchased in casual sale*—(1) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid against a purchaser (as defined in § 301.6323(h)-1(f)) of household goods, personal effects, or other tangible personal property of a type described in § 301.6334-1 (which includes wearing apparel; school books; fuel, provisions, furniture, arms for personal use; livestock, and poultry (whether or not the seller is the head of a family); and books and tools of a trade, business, or profession (whether or not the trade, business, or profession of the seller)), purchased, other than for resale, in a casual sale for less than $250 (excluding interest and expenses described in § 301.6323(e)-1). For purposes of this paragraph, a casual sale is a sale not made in the ordinary course of the seller's trade or business.

(2) *Limitation.* This paragraph applies only if the purchaser does not have actual notice or knowledge (as defined in paragraph (a) of § 301.6323(i)-1)—

(i) Of the existence of the tax lien, or

(ii) That the sale is one of a series of sales.

For purposes of subdivision (ii) of this subparagraph, a sale is one of a series of sales if the seller plans to dispose of, in separate transactions, substantially all of his household goods, personal effects, and other tangible personal property described in § 301.6334-1.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). A, an attorney's widow, sells a set of law books for $200 to B, for B's own use. Prior to the sale a notice of lien was filed with respect to A's delinquent tax liability in accordance with §301.6323(f)-1. B has no actual notice or knowledge of the tax lien. In addition, B does not know that the sale is one of a series of sales. Because the sale is a casual sale for less than $250 and involves books of a profession (tangible personal property of a type described in §301.6334-1, irrespective of the fact that A has never engaged in the legal profession), the tax lien is not valid against B even though a notice of lien was filed prior to the time of B's purchase.

Example (2). Assume the same facts as in example (1) except that B purchases the books for resale in his second-hand bookstore. Because B purchased the books for resale, he purchased the books subject to the lien.

Example (3). In an advertisement appearing in a local newspaper, G indicates that he is offering for sale a lawn mower, a used television set, a desk, a refrigerator, and certain used dining room furniture. In response to the advertisement, H purchases the dining room furniture for $200. H does not receive any information which would impart notice of a lien, or that the sale is one of a series of sales, beyond the information contained in the advertisement. Prior to the sale a notice of lien was filed with respect to G's delinquent tax liability in accordance with §301.6323(f)-1. Because H had no actual notice or knowledge that substantially all of G's household goods was being sold, or that the sale is one of a series of sales and because the sale is a casual sale for less than $250, H does not purchase the dining room furniture subject to the lien. The household goods are of a type described in §301.6334-1(a)(2) irrespective of whether G is the head of a family or whether all such household goods offered for sale exceed $500 in value.

(e) *Personal property subject to possessory liens.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid against a holder of a lien on tangible personal property which under local law secures the reasonable price of the repair or improvement of the property if the property is, and has been, continuously in the possession of the holder of the lien from the time the possessory lien arose. For example, if local law gives an automobile repairman the right to retain possession of an automobile he has repaired as security for payment of the repair bill and the repairman retains continuous possession of the automobile until his lien is satisfied, a tax lien filed in accordance with § 301.6323

(f)(1) which has attached to the automobile will not be valid to the extent of the reasonable price of the repairs. It is immaterial that the notice of tax lien was filed before the repairman undertook his work or that he knew of the lien before undertaking the work.

(f) *Real property tax and special assessment liens*—(1) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid against the holder of another lien upon the real property (regardless of when such other lien arises), if such other lien is entitled under local law to priority over security interests in real property which are prior in time if such other lien on real property secures payment of—

(i) A tax of general application levied by any taxing authority based upon the value of the property;

(ii) A special assessment imposed directly upon the property by any taxing authority, if the assessment is imposed for the purpose of defraying the cost of any public improvement; or

(iii) Charges for utilities or public services furnished to the property by the United States, a State or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

(2) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). A owns Blackacre in the City of M. A notice of lien affecting Blackacre is filed in accordance with §301.6323(f)-1. Subsequent to the filing of the notice of lien, the City of M acquires a lien against Blackacre to secure payment of real estate taxes. Such taxes are levied against all property in the city in proportion to the value of the property. Under local law, the holder of a lien for real property taxes is entited to priority over a security interest in real property even though the security interest is prior in time. Because the real property tax lien held by the City of M secures payment of a tax of general application and is entitled to priority over security interests which are prior in time, the lien held by the City of M is entitled to priority over the Federal tax lien with respect to Blackacre.

Example (2). B owns Whiteacre in N County. A notice of lien affecting Whiteacre is filed in accordance with §301.6323(f)-1. Subsequent to the filing of the notice of lien, N County constructs a sidewalk, paves the street, and installs water and sewer lines adjacent to Whiteacre. In order to defray the cost of these improvements, N County imposes upon Whiteacre a special assessment which under local law results in a lien upon Whiteacre that is entitled to priority over security interests that are prior in time. Because the special assessment lien is (i) entitled under local law to priority over security interests which are prior in time, and (ii) imposed directly upon real property to defray the cost of a public improvement, the special assessment lien has priority over the Federal tax lien with respect to Whiteacre.

Example (3). C owns Greenacre in Town O. A notice of lien affecting Greenacre is filed in accordance with §301.6323(f)-1. Town O furnishes water and electricity to Greenacre and periodically collects a fee for these services. Subsequent to the filing of the notice of lien, Town O supplies water and electricity to Greenacre, and C fails to pay the charges for these services. Under local law, Town O acquires a lien to secure charges for the services, and this lien has priority over security interests which are prior in time. Because the lien of Town O (i) is for services furnished to the real property and (ii) has priority over earlier security interests, Town O's lien has priority over the Federal tax lien with respect to Greenacre.

(g) *Residential property subject to a mechanic's lien for certain repairs and improvements*—(1) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid against a mechanic's lienor (as defined in § 301.6323(h)-1(b)) who holds a lien for the repair or improvement of a personal residence if—

(i) The residence is occupied by the owner and contains no more than four dwelling units, and

(ii) The contract price on the prime contract with the owner for the repair or improvement (excluding interest and expenses described in § 301.6323(e)-1) is not more than $1,000.

For purposes of subdivision (ii) of this subparagraph, the amounts of subcontracts under the prime contract with the owner are not to be taken into consideration for purposes of computing the $1,000 prime contract price. It is immaterial that the notice of tax lien was filed before the contractor undertakes his work or that he knew of the lien before undertaking the work.

(2) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). A owns a building containing four apartments, one of which he occupies as his personal residence. A notice of lien which affects the building is filed in accordance with §301.6323(f)-1. Thereafter, A enters into a contract with B in the amount of $800, which includes labor and materials, to repair the roof of the building. B purchases roofing shingles from C for $300. B completes the work and A fails to pay B the agreed amount. In turn, B fails to pay C for the shingles. Under local law, B and C acquire mechanic's liens on A's building. Because the contract price on the prime contract with A is not more than $1,000 and under local law B and C acquire mechanic's liens on A's building, the liens of B and C have priority over the Federal tax lien.

Example (2). Assume the same facts as in example (1), except that the amount of the prime contract between A and B is $1100. Because the amount of the prime contract with the owner, A, is in excess of $1,000, the tax lien has priority over the entire amount of each of the mechanic's liens of B and C, even though the amount of the contract between B and C is $300.

Example (3). Assume the same facts as in example (1), except that A and B do not agree in advance upon the amount due under the prime contract but agree that B will perform the work for the cost of materials and labor plus 10% of such cost. When the work is completed, it is determined that the total amount due is $850. Because the prime contract price is not more than $1,000 and under local law B and C acquire mechanic's liens on A's residence, the liens of B and C have priority over the Federal tax lien.

(h) *Attorneys' liens*—(1) *In general.* Even though notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid against an attorney who, under local law, holds a lien upon, or a contract enforceable against, a judgment or other amount in settlement of a claim or of a cause of action The priority afforded an attorney's lien under this paragraph shall not exceed the amount of the attorney's reasonable compensation for obtaining the judgment or procuring the settlement.

For purposes of this paragraph, reasonable compensation means the amount customarily allowed under local law for an attorney's services for litigating or settling a similar case or administrative claim. However, reasonable compensation shall be determined on the basis of the facts and circumstances of each individual case. It is immaterial that the notice of tax lien is filed before the attorney undertakes his work or that the attorney knows of the tax lien before undertaking his work. This paragraph does not apply to an attorney's lien which may arise from the defense of a claim or cause of action against a taxpayer except to the extent such lien is held upon a judgment or other amount arising from the adjudication or settlement of a counterclaim in favor of the taxpayer. In the case of suits against the taxpayer, see § 301.6325-1(d)(2) for rules relating to the subordination of the tax lien to facilitate tax collection.

(2) *Claim or cause of action against the United States.* Subparagraph (1) of this section does not apply to an attorney's lien with respect to—

(i) Any judgment or other fund resulting from the successful litigation or settlement of an administrative claim or cause of action against the United States to the extent that the United States, under any legal or equitable right, offsets its liability under the judgment or settlement against any liability of the taxpayer to the United States, or

(ii) Any amount credited against any liability of the taxpayer in accordance with section 6402.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). A notice of lien is filed against A in accordance with §301.6323(f)-1. Subsequently, A is struck by an automobile and retains B, an attorney to institute suit on A's behalf against the operator of the automobile. B knows of the tax lien before he begins his work. Under local law, B is entitled to a lien upon any recovery in order to secure payment of his fee. A is awarded damages of $10,000. B charges a fee of $3,000 which is the fee customarily allowed under local law in similar cases and which is found to be reasonable under the circumstances of this particular case. Because, under local law, B holds a lien for the amount of his reasonable compensation for obtaining the judgment, B's lien has priority over the Federal tax lien.

Example (2). Assume the same facts as in example (1), except that before suit is instituted A and the owner of the automobile settle out of court for $7,500. B charges a reasonable and customary fee of $1,800 for procuring the settlement and under local law holds a lien upon the settlement in order to secure payment of the fee. Because, under local law, B holds a lien for the amount of his reasonable compensation for obtaining the settlement, B has priority over the Federal tax lien.

Example (3). In accordance with §301.6323(f)-1, a notice of lien in the amount of $8,000 is filed against C, a contractor. Subsequently C retains D, an attorney, to initiate legal proceedings to recover the amount allegedly due him for construction work he has performed for the United States. C and D enter into an agreement which provides that D will receive a reasonable and customary fee of $2,500 as compensation for his services. Under local law, the agreement will give rise to a lien which is enforceable by D against any amount recovered in the suit. C is successful in the suit and is awarded $10,000. D claims $2,500 of the proceeds as his fee. The United States, however, exercises its right of set-off and applies $8,000 of the $10,000 award to satisfy C's tax liability. Because the $10,000 award resulted from the successful litigation of a cause of action against the United States, B's contract for attorney's fees is not enforceable against the amount recovered to the extent the United States offsets its liability under the judgment against C's tax liability. It is immaterial that D had no notice or knowledge of the tax lien at the time he began work on the case.

(i) *Certain insurance contracts—*(1) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid with respect to a life insurance, endowment, or annuity contract, against an organization which is the insurer under the contract, at any time—

(i) Before the insuring organization has actual notice or knowledge (as defined in paragraph (a) of § 301.6323(i)-1) of the existence of the tax lien,

(ii) After the insuring organization has actual notice or knowledge of the lien (as defined in paragraph (a) of § 301.6323(i)-1), with respect to advances (including contractual interest thereon as provided in paragraph (a) of § 301.6323(e)-1) required to be made automatically to maintain the contract in force under an agreement entered into before the insuring organization had such actual notice or knowledge, or

(iii) After the satisfaction of a levy pursuant to section 6332(b), unless and until the district director delivers to the insuring organization a notice (for example, another notice of levy, a letter, etc.), executed after the date of such satisfaction, that the lien exists.

Delivery of the notice described in subdivision (iii) of this subparagraph may be made by any means, including regular mail, and delivery of the notice shall be effective only from the time of actual receipt of the notification by the insuring organization. The provisions of this paragraph are applicable to matured as well as unmatured insurance contracts.

(2) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). On May 1, 1964, the X insurance company issues a life insurance policy to A. On June 1, 1970, a tax assessment is made against A, and on June 2, 1970, a notice of lien with respect to the assessment is filed in accordance with §301.6323(f)-1. On July 1, 1970, without actual notice or knowledge of the tax lien, the X Company makes a "policy loan" to A. Under subparagraph (1)(i) of this paragraph, the loan, including interest (in accordance with the provisions of paragraph (a) of § 301.6323(e)-1), will have priority over the tax lien because X Company did not have actual notice or knowledge of the tax lien at the time the policy loan was made.

Example (2). On May 1, 1964, B enters into a life insurance contract with the Y insurance company. Under one of the provisions of the contract, in the event a premium is not paid, Y is to advance out of the cash loan value of the policy the amount of an unpaid premium in order to maintain the contract in force. The contract also provides for interest on any advances so made. On June 1, 1971, a tax assessment is made against B, and on June 2, 1971, in accordance with section 6323(f)-1, a notice of lien is filed. On July 1, 1971, B fails to pay the premium due on

that date, and Y makes an automatic premium loan to keep the policy in force. At the time the automatic premium loan is made, Y had actual knowledge of the tax lien. Under subparagraph (1)(ii) of this paragraph, the lien is not valid against Y with respect to the advance (and the contractual interest thereon), because the advance was required to be made automatically under an agreement entered into before Y had actual notice or knowledge of the tax lien.

Example (3). On May 1, 1964, C enters into a life insurance contract with the Z Insurance Company. On January 4, 1971, an assessment is made against C for $5,000 unpaid income taxes, and on January 11, 1971, in accordance with § 301.6323(f)-1, a notice of lien is filed. On January 29, 1971, a notice of levy with respect to C's delinquent tax is served on Z Company. The amount which C could have had advanced to him from Z Company under the contract on the 90th day after service of the notice of levy on Z Company is $2,000. The Z Company pays $2,000 pursuant to the notice of levy, thereby satisfying the levy upon the contract in accordance with section 6332(b). On February 1, 1973, Z Company advances $500 to C, which is the increment in policy loan value since satisfaction of the levy of January 29, 1971. On February 5, 1973, a new notice of levy for the unpaid balance of the delinquent taxes, executed after the first levy was satisfied, is served upon Z Company. Because the new notification was not received by Z Company until after the policy loan was made, under paragraph (1)(iii) of this paragraph, the tax lien is not valid against Z Company with respect to the policy loan (including interest thereon in accordance with paragraph (a) of § 301.6323(e)-1).

Example (4). On June 1, 1973, a tax assessment is made against D and on June 2, 1973, in accordance with § 301.6323(f)-1, a notice of lien with respect to the assessment is filed. On July 2, 1973, D executes an assignment of his rights, as the insured under an insurance contract to M Bank as security for a loan. M Bank holds its security interest subject to the lien because it is not an insurer entitled to protection under section 6323(b)(9) and did not become a holder of the security interest prior to the filing of the notice of lien for purposes of section 6323(a). It is immaterial that a notice of levy had not been served upon the insurer before the assignment to M Bank was made.

(j) *Passbook loans*—(1) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid against an institution described in section 581 or 591 to the extent of any loan made by the institution which is secured by a savings deposit, share, or other account evidenced by a passbook (as defined in subparagraph (2) of this paragraph) if the institution has been continuously in possession of the passbook from the time the loan is made. This paragraph applies only to a loan made without actual notice or knowledge (as defined in paragraph (a) of § 301.6323(i)-1) of the existence of the lien. Even though an original passbook loan is made without actual notice or knowledge of the existence of the lien, this paragraph does not apply to any additional loan made after knowledge of the lien is acquired by the institution even if it continues to retain the passbook from the time the original passbook loan is made.

(2) *Definition of passbook.* For purposes of this paragraph, the term "passbook" includes—

(i) Any tangible evidence of a savings deposit, share, or other account which, when in the possession of the bank or other savings institution, will prevent a withdrawal from the account to the extent of the loan balance, and

(ii) Any procedure or system, such as an automatic data processing system, the use of which by the bank or other savings institution will prevent a withdrawal from the account to the extent of the loan balance.

(3) *Example.* On June 1, 1970, a tax assessment is made against A and on June 2, 1970, a notice of lien with respect to the assessment is filed in accordance with § 301.6323(f)-1. A owns a savings account at the M Bank with a balance of $1,000. On June 10, 1970, A borrows $300 from the M Bank using the savings account as security therefor. The M Bank is continuously in possession of the passbook from the time the loan is made and does not have actual notice or knowledge of the lien at the time of the loan. The tax lien is not valid against M Bank with respect to the passbook loan of $300 and accrued interest and expenses entitled to priority under § 301.6323(e)-1. Upon service of a notice of levy, the M Bank must pay over the savings account balance in excess of the amount of its protected interest in the account as determined on the date of levy.

§ 301.6323(c) Statutory provisions; validity and priority against certain persons; protection for certain commercial transactions financing agreements, etc.

Sec. 6323. *Validity and priority against certain persons.* * * *

(c) *Protection for certain commercial transactions financing agreements, etc.*—(1) *In general.* To the extent provided in this subsection, even though notice of a lien imposed by section 6321 has been filed such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which—

(A) Is in qualified property covered by the terms of a written agreement entered into before tax lien filing and constituting—

(i) A commercial transactions financing agreement,

(ii) A real property construction or improvement financing agreement, or

(iii) An obligatory disbursement agreement, and

(B) Is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

(2) *Commercial transactions financing agreement.* For purposes of this subsection—

(A) *Definition.* The term "commercial transactions financing agreement" means an agreement (entered into by a person in the course of his trade or business)—

(i) To make loans to the taxpayer to be secured by commercial financing security acquired by the taxpayer in the ordinary course of his trade or business, or

(ii) To purchase commercial financing security (other than inventory) acquired by the taxpayer in the ordinary course of his trade or business; but such an agreement shall be treated as coming within the term only to the extent that such loan or purchase is made before the 46th day after the date of tax lien filing or (if earlier) before the lender or purchaser has actual notice or knowledge of such tax lien filing.

(B) *Limitation on qualified property.* The term "qualified property", when used with respect to a commercial transaction financing agreement, includes only commercial financing security acquired by the taxpayer before the 46th day after the date of tax lien filing.

(C) *Commercial financing security defined.* The term "commercial financing security" means (i) paper of a kind ordinarily arising in commercial transactions, (ii) accounts receivable, (iii) mortgages on real property, and (iv) inventory.

(D) *Purchaser treated as acquiring security interest.* A person who satisfies subparagraph (A) by reason of clause (ii) thereof shall be treated as having acquired a security interest in commercial financing security.

(3) *Real property construction or improvement financing agreement.* For purposes of this subsection—

(A) *Definition.* The term "real property construction or improvement financing

agreement" means an agreement to make cash disbursements to finance—

(i) The construction or improvement of real property,

(ii) A contract to construct or improve real property, or

(iii) The raising or harvesting of a farm crop or the raising of livestock or other animals.

For purposes of clause (iii), the furnishing of goods and services shall be treated as the disbursement of cash.

(B) *Limitation on qualified property.* The term "qualified property", when used with respect to a real property construction or improvement financing agreement, includes only—

(i) In the case of subparagraph (A)(i), the real property with respect to which the construction or improvement has been or is to be made.

(ii) In the case of subparagraph (A)(ii), the proceeds of the contract described therein, and

(iii) In the case of subparagraph (A)(iii), property subject to the lien imposed by section 6321 at the time of tax lien filing and the crop or the livestock or other animals referred to in subparagraph (A)(iii).

(4) *Obligatory disbursement agreement.* For purposes of this subsection—

(A) *Definition.* The term "obligatory disbursement agreement" means an agreement (entered into by a person in the course of his trade or business) to make disbursements, but such an agreement shall be treated as coming within the term only to the extent of disbursements which are required to be made by reason of the intervention of the rights of a person other than the taxpayer.

(B) *Limitation on qualified property.* The term "qualified property", when used with respect to an obligatory disbursement agreement, means property subject to the lien imposed by section 6321 at the time of tax lien filing and (to the extent that the acquisition is directly traceable to the disbursements referred to in subparagraph (A)) property acquired by the taxpayer after tax lien filing.

(C) *Special rules for surety agreements.* Where the obligatory disbursement agreement is an agreement ensuring the performance of a contract between the taxpayer and another person—

(i) The term "qualified property" shall be treated as also including the proceeds of the contract the performance of which was ensured, and

(ii) If the contract the performance of which was ensured was a contract to construct or improve real property, to produce goods, or to furnish services, the term "qualified property" shall be treated as also including any tangible personal property used by the taxpayer in the performance of such ensured contract.

[Sec. 6323(c) as amended by sec. 101(a), Federal Tax Lien Act 1966 (80 Stat. 1125) [Pub. L. 89-719, 1966-2 C.B. 623]]

§ 301.6323(c)-1 Protection for commercial transactions financing agreements.

(a) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid with respect to a security interest which:

(1) Comes into existence after the tax lien filing,

(2) Is in qualified property covered by the terms of a commercial transactions financing agreement entered into before the tax lien filing, and

(3) Is protected under local law against a judgment lien arising, as of the time of the tax lien filing, out of an unsecured obligation. See paragraphs (a) and (e) of § 301.6323(h)-1 for definitions of the terms "security interest" and "tax lien filing", respectively. For purposes of this section, a judgment lien is a lien held by a judgment lien creditor as defined in paragraph (g) of § 301.6323(h)-1.

(b) *Commercial transactions financing agreement.* For purposes of this section, the term "commercial transactions financing agreement" means a written agreement entered into by a person in the course of his trade or business—

(1) To make loans to the taxpayer (whether or not at the option of the person agreeing to make such loans) to be secured by commercial financing security acquired by the taxpayer in the ordinary course of his trade or business, or

(2) To purchase commercial financing security, other than inventory, acquired by the taxpayer in the ordinary course of his trade or business.

Such an agreement qualifies as a commercial transactions financing agreement only with respect to loans or purchases made under the agreement before (i) the 46th day after the date of tax lien filing or, (ii) the time when the lender or purchaser has actual notice or knowledge (as defined in paragraph (a) of § 301.6323(i)-1) of the tax lien filing, if earlier. For purposes of this paragraph, a loan or purchase is considered to have been made in the course of the lender's or purchaser's trade or business if such person is in the business of financing commercial transactions (such as a bank or commercial factor) or if the agreement is incidental to the conduct of such person's trade or business. For example, if a manufacturer finances the accounts receivable of one of his customers, he is considered to engage in such financing in the course of his trade or business. The extent of the priority of the lender or purchaser over the tax lien is the amount of his disbursements made before the 46th day after the date the notice of tax lien is filed, or made before the date (before such 46th day) on which the lender or purchaser has actual notice or knowledge of the filing of the notice of the tax lien.

(c) *Commercial financing security*—(1) *In general.* The term "commercial financing security" means—

(i) Paper of a kind ordinarily arising in commercial transactions,

(ii) Accounts receivable (as defined in subparagraph (2) of this paragraph),

(iii) Mortgages on real property, and

(iv) Inventory.

For purposes of this subparagraph, the term "paper of a kind ordinarily arising in commercial transactions" in general includes any written document customarily used in commercial transactions. For example, such written documents include paper giving contract rights (as defined in subparagraph (2) of this paragraph), chattel paper, documents of title to personal property, and negotiable instruments or securities. The term "commercial financing security" does not include general intangibles such as patents or copyrights. A mortgage on real estate (including a deed of trust, contract for sale, and similar instrument) may be commercial financing security if the taxpayer has an interest in the mort-

gage as a mortgagee or assignee. The term "commercial financing security" does not include a mortgage where the taxpayer is the mortgagor of realty owned by him. For purposes of this subparagraph, the term "inventory" includes raw materials and goods in process as well as property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) *Definitions.* For purposes of §§ 301.6323(d)-1, 301.6323(h)-1 and this section—

(i) A contract right is any right to payment under a contract not yet earned by performance and not evidenced by an instrument or chattel paper, and

(ii) An account receivable is any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper.

(d) *Qualified property.* For purposes of paragraph (a) of this section, qualified property consists solely of commercial financing security acquired by the taxpayer-debtor before the 46th day after the date of tax lien filing. Commercial financing security acquired before such day may be qualified property even though it is acquired by the taxpayer after the lender received actual notice or knowledge of the filing of the notice of the tax lien. For example, although the receipt of actual notice or knowledge of the filing of the notice of the tax lien has the effect of ending the period within which protected disbursements may be made to the taxpayer, property which is acquired by the taxpayer after the lender receives actual notice or knowledge of such filing and before such 46th day, which otherwise qualifies as commercial financing security, becomes commercial financing security to which the priority of the lender extends for loans made before he received the actual notice or knowledge. An account receivable (as defined in paragraph (c)(2)(ii) of this section) is acquired by a taxpayer at the time, and to the extent, a right to payment is earned by performance. Chattel paper, documents of title, negotiable instruments, securities, and mortgages on real estate are acquired by a taxpayer when he obtains rights in the paper or mortgage. Inventory is acquired by the taxpayer when title passes to him. A contract right (as defined in paragraph (c)(2)(i) of this section) is acquired by a taxpayer when the contract is made. Identifiable proceeds, which arise from the collection or disposition of qualified property by the taxpayer, are considered to be acquired at the time such qualified property is acquired if the secured party has a continuously perfected security interest in the proceeds under local law. The term "proceeds" includes whatever is received when collateral is sold, exchanged, or collected. For purposes of this paragraph, the term "identifiable proceeds" does not include money, checks and the like which have been commingled with other cash proceeds. Property acquired by the taxpayer after the 45th day following tax lien filing, by the expenditure of proceeds, is not qualified property.

(e) *Purchaser treated as acquiring security interest.* A person who purchases commercial financing security, other than inventory, pursuant to a commercial transactions financing agreement is treated, for purposes of this section, as having acquired a security interest in the commercial financing security. In the case of a bona fide purchase at a discount, a purchaser of commercial financing security who satisfies the requirements of this section has priority over the tax lien to the full extent of the security.

(f) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). (i) On June 1, 1970, a tax is assessed against M, a tool manufacturer, with respect to his delinquent tax liability. On June 15, 1970, M enters into a written financing agreement with X, a bank. The agreement provides that, in consideration of such sums as X may advance to M, X is to have a security interest in all of M presently owned and subsequently acquire commercial paper, accounts receivabl and inventory (including inventory in th manufacturing stages and raw materials) On July 6, 1970, notice of the tax lien filed in accordance with § 301.6323(f)-1 On August 3, 1970, without actual notic or knowledge of the tax lien filing, X ad vances $10,000 to M. On August 5, 1970 M acquires additional inventory throug the purchase of raw materials. On Augus 20, 1970, M has accounts receivable, aris ing from the sale of tools, amounting t $5,000. Under local law, X's security inter est, arising by reason of the $10,000 ad vance on August 3, 1970, has priority, with respect to the raw materials and account receivable, over a judgment lien against M arising July 6, 1970 (the date of tax lier filing) out of an unsecured obligation.

(ii) Because the $10,000 advance wa made before the 46th day after the tax lien filing, and the accounts receivable in the amount of $5,000 and the raw materials were acquired by M before such 46th day, X's $10,000 security interest in the accounts receivable and the inventory has priority over the tax lien. The priority of X's security interest also extends to the proceeds, received on or after the 46th day after the tax lien filing, from the liquidation of the accounts receivable and inventory held by M on August 20, 1970, if X has a continuously perfected security interest in identifiable proceeds under local law. However, the priority of X's security interest will not extend to other property acquired with such proceeds.

Example (2). Assume the same facts as in example (1) except that on July 15, 1970, X has actual knowledge of the tax lien filing. Because an agreement does not qualify as a commercial transactions financing agreement when a disbursement is made after tax lien filing with actual knowledge of the filing, X's security interest will not have priority over the tax lien with respect to the $10,000 advance made on August 3, 1970.

Example (3). Assume the same facts as in example (1) except that, instead of additional inventory, on August 5, 1970, M acquires an account receivable as the result of the sale of machinery which M no longer needs in his business. Even though the account receivable was acquired by taxpayer M before the 46th day after tax lien filing, the tax lien will have priority over X's security interest arising in the account receivable pursuant to the earlier written agreement because the account receivable was not acquired by the taxpayer in the ordinary course of his trade or business.

Example (4). Pursuant to a written agreement with the N Manufacturing Company entered into on January 4, 1971, Y, a commercial factor, purchases the accounts receivable arising out of N's regular sales to its customers. On November 1, 1971, in accordance with § 301.6323(f)-1, a notice of lien is filed with respect to N's delin-

quent tax liability. On December 6, 1971, Y, without actual notice or knowledge of the tax lien filing, purchases all of the accounts receivable resulting from N's November 1971 sales. Y has taken appropriate steps under local law so that the December 6, 1971, purchase is protected against a judgment lien arising November 1, 1971 (the date of tax lien filing) out of an unsecured obligation. Because the purchaser of commercial financing security, other than inventory, is treated as having acquired a security interest in commercial financing security, and because Y otherwise meets the requirements of this section, the tax lien is not valid with respect to Y's December 6, 1971, purchase of N's accounts receivable.

§ 301.6323(c)-2 Protection for real property construction or improvement financing agreements.

(a) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323 (f)-1, the lien is not valid with respect to a security interest which:

(1) Comes into existence after the tax lien filing,

(2) Is in qualified property covered by the terms of a real property construction or improvement financing agreement entered into before the tax lien filing, and

(3) Is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

For purposes of this section, it is immaterial that the holder of the security interest had actual notice or knowledge of the lien at the time disbursements are made pursuant to such an agreement. See paragraphs (a) and (e) of § 301.6323(h)-1 for general definitions of the terms "security interest" and "tax lien filing." For purposes of this section, a judgment lien is a lien held by a judgment lien creditor as defined in paragraph (g) of § 301.6323(h)-1.

(b) *Real property construction or improvement financing agreement.* For purposes of this section, the term "real property construction or improvement financing agreement" means any written agreement to make cash disbursements (whether or not at the option of the party agreeing to make such disbursements):

(1) To finance the construction, improvement, or demolition of real property if the agreement provides for a security interest in the real property with respect to which the construction, improvement, or demolition has been or is to be made;

(2) To finance a contract to construct or improve, or demolish real property if the agreement provides for a security interest in the proceeds of the contract; or

(3) To finance the raising or harvesting of a farm crop or the raising of livestock or other animals if the agreement provides for a security interest in any property subject to the lien imposed by section 6321 at the time of tax lien filing, in the crop raised or harvested, or in the livestock or other animals raised.

For purposes of subparagraphs (1) and (2) of this paragraph, construction or improvement may include demolition. For purposes of any agreement described in subparagraph (3), the furnishing of goods and services is treated as the disbursement of cash.

(c) *Qualified property.* For purposes of this section, the term "qualified property" includes only—

(1) In the case of an agreement described in paragraph (b)(1) of this section, the real property with respect to which the construction or improvement has been or is to be made;

(2) In the case of an agreement described in paragraph (b)(2) of this section, the proceeds of the contract to construct or improve real property; or

(3) In the case of an agreement described in paragraph (b)(3) of this section, property subject to the lien imposed by section 6321 at the time of tax lien filing, the farm crop raised or harvested, or the livestock or other animals raised.

(d) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, in order to finance the construction of a dwelling on a lot owned by him, mortgages the property to B. The mortgage, executed January 4, 1971, includes an agreement that B will make cash disbursements to A as the construction progresses. On February 1, 1971, in accordance with § 301.6323(f)-1, a notice of lien is filed with respect to A's delinquent tax liability. A continues the construction, and B makes cash disbursements on June 10, 1971, and December 10, 1971. Under local law B's security interest arising by virtue of the disbursements is protected against a judgment lien arising February 1, 1971 (the date of tax lien filing) out of an unsecured obligation. Because B is the holder of a security interest coming into existence by reason of cash disbursements made pursuant to a written agreement, entered into before tax lien filing, to make cash disbursements to finance the construction, of real property, and because B's security interest is protected, under local law, against a judgment lien arising as of the time of tax lien filing out of an unsecured obligation, B's security interest has priority over the tax lien.

Example (2). (i) C is awarded a contract for the demolition of several buildings. On March 3, 1969, C enters into a written agreement with D which provides that D will make cash disbursements to finance the demolition and also provides that repayment of the disbursements is secured by any sums due C under the contract. On April 1, 1969, in accordance with § 301.6323(f)-1, a notice of lien is filed with respect to C's delinquent tax liability. With actual notice of the tax lien, D makes cash disbursements to C on August 1, September 1, and October 1, 1969. Under local law D's security interest in the proceeds of the contract with respect to the disbursements is entitled to priority over a judgment lien arising on April 1, 1969 (the date of tax lien filing) out of an unsecured obligation.

(ii) Because D's security interest arose by reason of disbursements made pursuant to a written agreement, entered into before tax lien filing, to make cash disbursements to finance a contract to demolish real property, and because D's security interest is valid under local law against a judgment lien arising as of the time of tax lien filing out of an unsecured obligation, the tax lien is not valid with respect to D's security interest in the proceeds of the demolition contract.

Example (3). Assume the same facts as in example (2) and, in addition, assume that, as further security for the cash disbursements, the March 3, 1969 agreement also provides for a security interest in all of C's demolition equipment. Because the protection of the security interest arising from the disbursements made after tax lien filing under the agreement is limited under section 6323(c)(3) to the proceeds of the demolition contract and because, under the circumstances, the security interest in the equipment is not otherwise protected

under section 6323, the tax lien will have priority over D's security interest in the equipment.

Example (4). (i) On January 2, 1969, F and G enter into a written agreement whereby F agrees to provide G with cash disbursements, seed, fertilizer, and insecticides as needed by G, in order to finance the raising and harvesting of a crop on a farm owned by G. Under the terms of the agreement F is to have a security interest in the crop, the farm, and all other property then owned or thereafter acquired by G. In accordance with § 301.6323(f)-1, on January 10, 1969, a notice of lien is filed with respect to G's delinquent tax liability. On March 3, 1969, with actual notice of the tax lien, F makes a cash disbursement of $5,000 to G and furnishes him seed, fertilizer, and insecticides having a value of $10,000. Under local law F's security interest, coming into existence by reason of the cash disbursement and the furnishing of goods, has priority over a judgment lien arising January 10, 1969 (the date of tax lien filing) out of an unsecured obligation.

(ii) Because F's security interest arose by reason of a disbursement (including the furnishing of goods) made under a written agreement which was entered into before tax lien filing and which constitutes an agreement to finance the raising or harvesting of a farm crop, and because F's security interest is valid under local law against a judgment lien arising as of the time of tax lien filing out of an unsecured obligation, the tax lien is not valid with respect to F's security interest in the crop even though a notice of lien was filed before the security interest arose. Furthermore, because the farm is property subject to the tax lien at the time of tax lien filing, F's security interest with respect to the farm also has priority over the tax lien.

Example (5). Assume the same facts as in example (4) and in addition that on October 1, 1969, G acquires several tractors to which F's security interest attaches under the terms of the agreement. Because the tractors are not property subject to the tax lien at the time of tax lien filing, the tax lien has priority over F's security interest in the tractors.

§ 301.6323(c)-3 Protection for obligatory disbursement agreements.

(a) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid with respect to a security interest which:

(1) Comes into existence after the tax lien filing,

(2) Is in qualified property covered by the terms of an obligatory disbursement agreement entered into before the tax lien filing, and

(3) Is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

See paragraphs (a) and (e) of § 301.6323(h)-1 for definitions of the terms "security interest" and "tax lien filing." For purposes of this section, a judgment lien is a lien held by a judgment lien creditor as defined in paragraph (g) of § 301.6323(h)-1.

(b) *Obligatory disbursement agreement.* For purposes of this section the term "obligatory disbursement agreement" means a written agreement, entered into by a person in the course of his trade or business, to make disbursements. An agreement is treated as an obligatory disbursement agreement only with respect to disbursements which are required to be made by reason of the intervention of the rights of a person other than the taxpayer. The obligation to pay must be conditioned upon an event beyond the control of the obligor. For example, the provisions of this section are applicable where an issuing bank obligates itself to honor drafts or other demands for payment on a letter of credit and a bank, in good faith, relies upon that letter of credit in making advances. The provisions of this section are also applicable, for example, where a bonding company obligates itself to make payments to indemnify against loss or liability and, under the terms of the bond, makes a payment with respect to a loss. The priority described in this section is not applicable, for example, in the case of an accommodation endorsement by an endorser who assumes his obligation other than in the course of his trade or business.

(c) *Qualified property.* Except as provided under paragraph (d) of this section, the term "qualified property", for purposes of this section, means property subject to the lien imposed by section 6321 at the time of tax lien filing and, to the extent that the acquisition is directly traceable to the obligatory disbursement, property acquired by the taxpayer after tax lien filing.

(d) *Special rule for surety agreements.* Where the obligatory disbursement agreement is an agreement ensuring the performance of a contract of the taxpayer and another person, the term "qualified property" shall be treated as also including—

(1) The proceeds of the contract the performance of which was ensured, and

(2) If the contract the performance of which was ensured is a contract to construct or improve real property, to produce goods, or to furnish services, any tangible personal property used by the taxpayer in the performance of the ensured contract.

For example, a surety company which holds a security interest, arising from cash disbursements made after tax lien filing under a payment or performance bond on a real estate construction project, has priority over the tax lien with respect to the proceeds of the construction contract and, in addition, with respect to any tangible personal property used by the taxpayer in the construction project if its security interest in the tangible personal property is protected under local law against a judgment lien arising, as of the time the tax lien was filed, out of an unsecured obligation.

(e) *Examples.* This section may be illustrated by the following examples:

Example (1). (i) On January 2, 1969, H, an appliance dealer, in order to finance the acquisition from O of a large inventory of appliances, enters into a written agreement with Z, a bank. Under the terms of the agreement, in return for a security interest in all of H's inventory, presently owned and subsequently acquired, Z issues an irrevocable letter of credit to allow H to make the purchase. On December 31, 1968 and January 10, 1969, in accordance with § 301.6323(f)-1, separate notices of lien are filed with respect to H's delinquent tax liabilities. On March 31, 1969, Z honors the letter of credit. Under local law, Z's security interest in both existing and after-acquired inventory is protected against a judgment lien arising on or after

January 10, 1969, out of an unsecured obligation. Under local law, Z's security interest in the inventory purchased under the letter of credit qualifies as a purchase money security interest and is valid against persons acquiring security interests in or liens upon such inventory at any time.

(ii) Because Z's security interest in H's inventory did not arise under a written agreement entered into before the filing of notice of the first tax lien on December 31, 1968, that lien is superior to Z's security interest except to the extent of Z's purchase money security interest. Because Z's interest qualifies as a purchase money security interest with respect to the inventory purchased under the letter of credit, the tax liens attach under section 6321 only to the equity acquired by H, and the rights of Z in the inventory so purchased are superior even to the lien filed on December 31, 1968, without regard to this section.

(iii) Because Z's security interest arose by reason of disbursements made under a written agreement which was entered into before the filing of notice of the second tax lien on January 10, 1969, and which constitutes an agreement to make disbursements required to be made by reason of the intervention of the rights of O, a person other than the taxpayer, and because Z's security interest is valid under local law against a judgment lien arising as of the time of such tax lien filing on January 10, 1969, out of an unsecured obligation, the second tax lien is, under this section, not valid with respect to Z's security interest in inventory owned by H on January 10, 1969, as well as any after-acquired inventory directly traceable to Z's disbursements (apart from such greater protection as Z enjoys, with respect to the latter, under its purchase money security interest). No protection against the second tax lien is provided under this section with respect to a security interest in any other inventory acquired by H after January 10, 1969, because such other inventory is neither subject to the tax lien at the time of tax lien filing nor directly traceable to Z's disbursements.

Example (2). On June 1, 1971, K is awarded a contract to construct an office building. At the same time, S, a surety company, agrees in writing to ensure the performance of the contract. The agreement provides that in the event S must complete the job as the result of a default by K, S will be entitled to the proceeds of the contract. In addition, the agreement provides that S is to have a security interest in all property belonging to K. On December 1, 1971, prior to the completion of the building, K defaults. On the same date, under § 301.6323(f)-1, a notice of lien is filed with respect to K's delinquent tax liability. S completes the building on June 1, 1972. Under local law S's security interest in the proceeds of the contract and S's security interest in the property of K are entitled to priority over a judgment lien arising December 1, 1971 (the date of tax lien filing) out of an unsecured obligation. Because, for purposes of an obligatory disbursement agreement which is a surety agreement, the security interest may be in the proceeds of the ensured contract, S's security interest in the proceeds of the contract has priority over the tax lien even though a notice of lien was filed before S's security interest arose. Furthermore, because the ensured contract was a contract to construct real property, S's security interest in any of K's tangible personal property used in the performance of the contract also has priority over the tax lien.

Example (3). (i) On February 2, 1970, L enters into an agreement with M, a contractor, to construct an apartment building on land owned by L. Under a separate agreement, N Bank agrees to furnish funds on a short-term basis to L for the payment of amounts due to M during the course of construction. Simultaneously, X, a financial institution, makes a binding commitment to N Bank and L to provide long-term financing for the project after its completion. Under its commitment, X is obligated to pay off the balance of the construction loan held by N Bank upon the execution by L of a new promissory note secured by a mortgage deed of trust upon the improved property. On September 4, 1970, in accordance with § 301.6323(f)-1, notice of lien is properly filed with respect to L's delinquent tax liability. On September 8, 1970, X obtains actual notice of the tax lien filing. On September 14, 1970, the documents creating X's security interest are executed and recorded, N Bank's lien for its construction loan is released, and X makes the required disbursements to N Bank. Under local law, X's security interest is protected against a judgment lien arising on September 4, 1970 (the time of tax lien filing) out of an unsecured obligation.

(ii) Because X's security interest arose by reason of a disbursement made under a written agreement entered into before tax lien filing, which constitutes an agreement to make disbursements required to be made by reason of the intervention of the rights of N Bank, a person other than the taxpayer, and because X's security interest is valid under local law against a judgment lien arising as of the time of the tax lien filing out of an unsecured obligation, the tax lien is not valid with respect to X's security interest to the extent of the disbursement to N Bank. The obligatory disbursement is protected under section 6323(c)(4) even if X is not subrogated to N Bank's rights or X's agreement is not itself a real property construction financing agreement.

§ 301.6323(d) Statutory provisions; validity and priority against certain persons; 45-day period for making disbursements.

Sec. 6323. *Validity and priority against certain persons.*

* * * * *

(d) *45-day period for making disbursements.* Even though notice of a lien imposed by Section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing by reason of disbursements made before the 46th day after the date of tax lien filing, or (if earlier) before the person making such disbursements had actual notice or knowledge of tax lien filing, but only if such security interest—

(1) Is in property (A) subject, at the time of tax lien filing, to the lien imposed by section 6321, and (B) covered by the terms of a written agreement entered into before tax lien filing, and

(2) Is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

[Sec. 6323(d) as amended by sec. 236(a) Rev. Act 1964 (78 Stat. 127) [Pub. L. 88-272, 1964-1 (Part 2) C.B. 6]; sec. 101(a) Federal Tax Lien Act 1966 (80 Stat. 1125) [Pub. L. 89-719, 1966-2 C.B. 623]]

§ 301.6323(d)-1 45-day period for making disbursements.

(a) *In general.* Even though a notice of a lien imposed by section 6321 is filed in accordance with § 301.6323(f)-1, the lien is not valid with respect to a security interest which comes into existence, after tax lien filing, by reason of disbursements made before the 46th day after the date of tax lien filing, or if earlier, before the person making the disbursements has actual notice or knowledge of the tax lien filing, but only if the security interest is—

(1) In property which is subject, at the time of tax lien filing, to the lien imposed by section 6321 and which is covered by the terms of a written agreement entered into before tax lien filing, and

(2) Protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

For purposes of subparagraph (1) of this paragraph, a contract right (as defined in paragraph (c)(2)(i) of §301.6323(c)-1) is subject, at the time of tax lien filing, to the lien imposed by section 6321 if the contract has been

made by such time. An account receivable (as defined in paragraph (c)(2)(ii) of § 301.6323(c)-1) is subject, at the time of tax lien filing, to the lien imposed by section 6321 if, and to the extent, a right to payment has been earned by performance at such time. For purposes of subparagraph (2) of this paragraph, a judgment lien is a lien held by a judgment lien creditor as defined in paragraph (g) of § 301.6323(h)-1. For purposes of this section, it is immaterial that the written agreement provides that the disbursements are to be made at the option of the person making the disbursements. See paragraphs (a) and (e) of § 301.6323(h)-1 for definitions of terms "security interest" and "tax lien filing", respectively. See paragraph (a) of § 301.6323(i)-1 for certain circumstances under which a person is deemed to have actual notice or knowledge of a fact.

(b) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). On December 1, 1967, an assessment is made against A with respect to his delinquent tax liability. On January 2, 1968, A enters into a written agreement with B whereby B agrees to lend A $10,000 in return for a security interest in certain property owned by A. On January 10, 1968, in accordance with § 301.6323(f)-1 notice of the tax lien affecting the property is filed. On February 1, 1968, B, without actual notice or knowledge of the tax lien filing, disburses the loan to A. Under local law, the security interest arising by reason of the disbursement is entitled to priority over a judgment lien arising January 10, 1968 (the date of tax lien filing) out of an unsecured obligation. Because the disbursement was made before the 46th day after tax lien filing, because the disbursement was made pursuant to a written agreement entered into before tax lien filing, and because the resulting security interest is protected under local law against a judgment lien arising as of the date of tax lien filing out of an unsecured obligation, B's $10,000 security interest has priority over the tax lien.

Example (2). Assume the same facts as in example (1) except that when B disburses the $10,000 to A on February 10, 1968, B has actual knowledge of the tax lien filing. Because the disbursement was made with actual knowledge of tax lien filing, B's security interest does not have priority over the tax lien even though the disbursement was made before the 46th day after the tax lien filing. Furthermore, B is not protected under § 301.6323(a)-1(a) as a holder of a security interest because he had not parted with money or money's worth prior to the time the notice of tax lien was filed (January 10, 1968) even though he had made a firm commitment to A before that time.

§ 301.6323(e) Statutory provisions; validity and priority against certain persons; priority of interest and expenses.

Sec. 6323. *Validity and priority against certain persons.* * * *

(e) *Priority of interest and expenses.* If the lien imposed by section 6321 is not valid as against a lien or security interest, the priority of such lien or security interest shall extend to—

(1) Any interest or carrying charges upon the obligation secured,

(2) The reasonable charges and expenses of an indenture trustee or agent holding the security interest for the benefit of the holder of the security interest.

(3) The reasonable expenses, including reasonable compensation for attorneys, actually incurred in collecting or enforcing the obligation secured,

(4) The reasonable costs of insuring, preserving, or repairing the property to which the lien or security interest relates,

(5) The reasonable costs of insuring payment of the obligation secured, and

(6) Amounts paid to satisfy any lien on the property to which the lien or security interest relates, but only if the lien so satisfied is entitled to priority over the lien imposed by section 6321,

to the extent that, under local law, any such item has the same priority as the lien or security interest to which it relates.

[Sec. 6323(e) as amended by sec. 236(a) Rev. Act 1964 (78 Stat. 127) [Pub. L. 88-272, 1964-1 (Part 2) C.B. 6]; sec. 101(a), Federal Tax Lien Act 1966 (80 Stat. 1125) [Pub. L. 89-719, 1966-2 C.B. 623]]

§ 301.6323(e)-1 Priority of interest and expenses.

(a) *In general.* If the lien imposed by section 6321 is not valid as against another lien or security interest, the priority of the other lien or security interest also extends to each of the following items to the extent that under local law the item has the same priority as the lien or security interest to which it relates:

(1) Any interest or carrying charges (including finance, service, and similar charges) upon the obligation secured,

(2) The reasonable charges and expenses of an indenture trustee (including, for example, the trustee under a deed of trust) or agent holding the security interest for the benefits of the holder of the security interest,

(3) The reasonable expenses, including reasonable compensation for attorneys, actually incurred in collecting or enforcing the obligation secured,

(4) The reasonable cost of insuring, preserving, or repairing the property to which the lien or security interest relates,

(5) The reasonable costs of insuring payment of the obligation secured (including amounts paid by the holder of the security interest for mortgage insurance, such as that issued by the Federal Housing Administration), and

(6) Amounts paid to satisfy any lien on the property to which the lien or security interest relates, but only if the lien so satisfied is entitled to priority over the lien imposed by section 6321.

(b) *Collection expenses.* The reasonable expenses described in paragraph (a)(3) of this section include expenditures incurred by the protected holder of the lien or security interest to establish the priority of his interest or to collect, for foreclosure or otherwise, the amount due him from the property subject to his lien. Accordingly, the amount of the encumbrance which is protected is increased by the amounts so expended by the holder of the security interest.

(c) *Costs of insuring, preserving, etc.* The reasonable costs of insuring, preserving, or repairing described in paragraph (a)(4) of this section include expenditures by the holder of a security interest for fire and casualty insurance on the property subject to the security interest and amounts paid by the holder of the lien or security interest to repair the property. Such reasonable costs also include the amounts paid by the holder of the lien or security interest in a leasehold to the lessor of the leasehold to preserve the leasehold subject to the lien or

security interest. Accordingly, the amount of the lien or security interest which is protected is increased by the amounts so expended by the holder of the lien or security interest.

(d) *Satisfaction of liens.* The amounts described in paragraph (a)(6) of this section include expenditures incurred by the protected holder of a lien or security interest to discharge a statutory lien for state sales taxes on the property subject to his lien or security interest if both his lien or security interest and the sales tax lien have priority over a Federal tax lien. Accordingly, the amount of the lien or security interest is increased by the amounts so expended by the holder of the lien or security interest even though under local law the holder of the lien or security interest is not subrogated to the rights of the holder of the state sales tax lien. However, if the holder of the lien or security interest is subrogated, within the meaning of paragraph (b) of § 301.6323(i)-1, to the rights of the holder of the sales tax lien, he will also be entitled to any additional protection afforded by section 6323(i)(2).

§ 301.6323(f) Statutory provisions; validity and priority against certain persons; place for filing notice; form.

Sec. 6323. *Validity and priority against certain persons.* * * *

(f) *Place for filing notice; form*—(1) *Place for filing.* The notice referred to in subsection (a) shall be filed—

(A) *Under state laws*—(i) *Real property.* In the case of real property, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated; and

(ii) *Personal property.* In the case of personal property, whether tangible or intangible, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated; or

(B) *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 has not by law designated one office which meets the requirements of subparagraph (A); or

(C) *With recorder of deeds of the District of Columbia.* In the office of the Recorder of Deeds of the District of Columbia, if the property subject to the lien is situated in the District of Columbia.

(2) *Situs of property subject to lien.* For purposes of paragraph (1), property shall be deemed to be situated—

(A) *Real property.* In the case of real property, at its physical location; or

(B) *Personal property.* In the case of personal property, whether tangible or intangible, at the residence of the taxpayer at the time of the notice of lien is filed.

For purposes of paragraph (2)(B), the residence of a corporation or partnership shall be deemed to be the place at which the principal executive office of the business is located, and the residence of a taxpayer whose residence is without the United States shall be deemed to be in the District of Columbia.

(3) *Form.* The form and content of the notice referred to in subsection (a) shall be prescribed by the Secretary or his delegate. Such notice shall be valid notwithstanding any other provision of law regarding the form or content of a notice of lien.

[Sec. 6323(f) as added by sec. 101(a) Federal Tax Lien Act 1966 (80 Stat. 1125) [Pub. L. 89-719, 1966-2 C.B. 623]]

§ 301.6323(f)-1 Place for filing notice; form.

(a) *Place for filing.* The notice of lien referred to in § 301.6323(a)-1 shall be filed as follows:

(1) *Under State laws*—(i) *Real property.* In the case of real property, notice shall be filed in one office within the State (or the county or other governmental subdivision), as designated by the laws of the State, in which the property subject to the lien is deemed situated under the provisions of paragraph (b)(1) of this section.

(ii) *Personal property.* In the case of personal property, whether tangible or intangible, the notice shall be filed in one office within the State (or the county or other governmental subdivision), as designated by the laws of the State, in which the property subject to the lien is deemed situated under the provisions of paragraph (b)(2) of this section.

(2) *With the clerk of the United States district court.* Whenever a State has not by law designated one office which meets the requirements of subparagraph (1)(i) or (1)(ii) of this paragraph, the notice shall be filed 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 deemed situated under the provisions of paragraph (b) of this section. For example, a State has not by law designated one office meeting the requirements of subparagraph (1)(i) of this paragraph if more than one office is designated within the State, county, or other governmental subdivision for filing notices with respect to all real property located in such State, county, or other governmental subdivision. A State has not by law designated one office meeting the requirements of subparagraph (1)(ii) of this paragraph if more than one office is designated in the State, county, or other governmental subdivision for filing notices with respect to all of the personal property of a particular taxpayer.

(3) *With the Recorder of Deeds of the District of Columbia.* If the property subject to the lien imposed by section 6321 is deemed situated, under the provisions of paragraph (b) of this section, in the District of Columbia, the notice shall be filed in the office of the Recorder of Deeds of the District of Columbia.

(b) *Situs of property subject to lien.* For purposes of paragraph (a) of this section, property is deemed situated as follows:

(1) *Real property.* Real property is deemed situated at its physical location.

(2) *Personal property.* Personal property, whether tangible or intangible, is deemed situated at the residence of the taxpayer at the time the notice of lien is filed.

For purposes of subparagraph (2) of this paragraph the residence of a corporation or partnership is deemed to be the place at which the principal executive office of the business is located, and the residence of a taxpayer whose residence is not within the

United States is deemed to be in the District of Columbia.

(c) *Form.* The notice referred to in § 301.6323(a)-1 shall be filed on Form 668, "Notice of Federal Tax Lien under Internal Revenue Laws". Such notice is valid notwithstanding any other provision of law regarding the form or content of a notice of lien. For example, omission from the notice of lien of a description of the property subject to the lien does not affect the validity thereof even though state law may require that the notice contain a description of the property subject to the lien.

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). The law of State X provides that notices of Federal tax lien affecting personal property are to be filed in the Office of the Recorder of Deeds of the county where the taxpayer resides. The laws of State X also provide that notices of lien affecting real property are to be filed with the recorder of deeds of the county where the real property is located. On June 1, 1970, in accordance with § 301.6323(f)-1, a notice of lien is filed in County M with respect to the delinquent tax liability of A. At the time the notice is filed, A is a resident of County M and owns real property in that county. One year later A moves to County N and one year after that A moves to County O. Because the situs of personal property is deemed to be at the residence of the taxpayer at the time the notice of lien is filed, the notice continues to be effectively filed with respect to A's personal property even though A no longer resides in County M. Furthermore, because the situs of real property is deemed to be at its physical location, the notice of lien also continues to be effectively filed with respect to A's real property.

Example (2). B is a resident of Canada but owns personal property in the United States. On January 4, 1971, in accordance with § 301.6323(f)-1, a notice of lien is filed with the office of the Recorder of Deeds of the District of Columbia. On January 2, 1973, B changes his residence to State Y in the United States. Because the residence of a taxpayer who is not a resident of the United States is deemed to be in the District of Columbia and the situs of personal property is deemed to be at the residence of the taxpayer at the time of filing, the lien continues to be effectively filed with respect to the personal property of B located in the United States even though B has returned to the United States and taken up residence in State Y and even though B has at no time been in the District of Columbia.

Example (3). The law of State Z in effect before July 1, 1967, provides that notices of lien affecting real property are to be filed in the office of the recorder of deeds of the county in which the real property is located, but that if the real property is registered under the Torrens system of title registration the notice is to be filed with the registrar of titles rather than the recorder of deeds. The law of State Z in effect after June 30, 1967, provides that all notices of lien affecting real property are to be filed with the recorder of deeds of the county in which the real property is located. Accordingly, where the Torrens system is adopted by a county in State Z, there were before July 1, 1967, two offices designated for filing notices of Federal tax lien affecting real property in the county because one office was designated for Torrens real property and another office was designated for non-Torrens real property. Because State Z had not designated one office within the State, county or other governmental subdivision for filing notices before July 1, 1967, with respect to all real property located in the State, county, or governmental subdivision, before July 1, 1967, the place for filing notices of lien under this section, affecting property located in counties adopting the Torrens system, was with the clerk of the United States district court for the judicial district in which the real property is located. However, after June 30, 1967, the place for filing notices of lien under this section, affecting both Torrens and non-Torrens real property in counties adopting the Torrens system is with the recorder of deeds for each such county. Notices of lien filed under this section with the clerk of the United States district court before July 1, 1967, remain validly filed whether or not refiled with the recorder of deeds after the change in state law or upon refiling during the required refiling period.

Example (4). The law of State W provides that notices of lien affecting personal property of corporations and partnerships are to be filed in the office of the Secretary of State. Notices of lien affecting personal property of any other person are to be filed in the office of the clerk of court for the county where the person resides. Because the state law designates only one filing office within State W with respect to personal property of any particular taxpayer, notices of lien filed under this section, affecting personal property, shall be filed in the office designated under state law.

§ 301.6323(g) Statutory provisions; validity and priority against certain persons; refiling of notice of tax lien.

Sec. 6323. *Validity and priority against certain persons.* * * *

(g) *Refiling of Notice.*—For purposes of this section—

(1) *General Rule.*—Unless notice of lien is refiled in the manner prescribed in paragraph (2) during the required refiling period, such notice of lien shall be treated as filed on the date on which it is filed (in accordance with subsection (f) after the expiration of such refiling period.

(2) *Place For Filing.*—A notice of lien refiled during the required refiling period shall be effective only—

(A) If such notice of lien is refiled in the office in which the prior notice of lien was filed; and

(B) In any case in which, 90 days or more prior to the date of a refiling of notice of lien under subparagraph (A), the Secretary or his delegate received written information (in the manner prescribed in regulations issued by the taxpayer's residence, if a notice of such lien is also filed in accordance with subsection (f) in the State in which such residence is located.

(3) *Required Refiling Period.*—In the case of any notice of lien, the term "required refiling period" means—

(A) The one-year period ending 30 days after the expiration of 6 years after the date of the assessment of the tax, and

(B) The one-year period ending with the expiration of 6 years after the close of the preceding required refiling period for such notice of lien.

(4) *Transitional Rule.*—Notwithstanding paragraph (3), if the assessment of the tax was made before January 1, 1962, the first required refiling period shall be the calendar year 1967.

[Sec. 6323(g) as added by sec. 101(a), Federal Tax Lien Act 1966 (80 Stat. 1125) [Pub. L. 89-719, 1966-2 C.B. 623]]

§ 301.6323(g)-1 Refiling of notice of tax lien.

(a) *In general*—(1) *Requirement to refile.* In order to continue the effect of a notice of lien, the notice must be refiled in the place described in paragraph (b) of this section during the required refiling period (described in paragraph (c) of this section). In the event that two or more notices of lien are filed with respect to a particular tax assessment, the failure to comply with the provisions of paragraphs (b)(1)(i) and (c) of this section in respect of one of the notices of lien does not affect the effectiveness of the refiling of any other notice of lien. Except for the filing of a notice of lien required by paragraph (b)(1)(ii) of this section (relating to a change of

residence) the validity of any refiling of a notice of lien is not affected by the refiling or non-refiling of any other notice of lien.

(2) *Effect of refiling.* A timely refiled notice of lien is effective as of the date on which the notice of lien to which it relates was effective.

(3) *Effect of failure to refile.* If the district director fails to refile a notice of lien in the manner described in paragraphs (b) and (c) of this section, the notice of lien is not effective, after the expiration of the required refiling period, as against any person without regard to when the interest of the person in the property subject to the lien was acquired. However, the failure of the district director to refile a notice of lien during the required refiling period will not, following the expiration of the refiling period, affect the effectiveness of the notice with respect to:

(i) Property which is the subject matter of a suit, to which the United States is a party, commenced prior to the expiration of the required refiling period, or

(ii) Property which has been levied upon by the United States prior to the expiration of the refiling period.

However, if a suit or levy referred to in the preceding sentence is dismissed or released and the property is subject to the lien at such time, a notice of lien with respect to the property is not effective after the suit or levy is dismissed or released unless refiled during the required refiling period. Failure to refile a notice of lien does not affect the existence of the lien.

(4) *Filing of new notice.* If a notice of lien is not refiled, and if the lien remains in existence, the Internal Revenue Service may nevertheless file a new notice of lien either on the form prescribed for the filing of a notice of lien or on the form prescribed for refiling a notice of lien. This new filing must meet the requirements of section 6323(f) and § 301.6323(f)-1 and is effective from the date on which such filing is made.

(b) *Place for refiling notice of lien*—(1) *In general.* A notice of lien refiled during the required refiling period (described in paragraph (c) of this section) shall be effective only—

(i) If the notice of lien is refiled in the office in which the prior notice of lien (including a refiled notice) was filed under the provisions of section 6323; and

(ii) In any case in which 90 days or more prior to the date the refiling of the notice of lien under subdivision (i) is completed, the Internal Revenue Service receives written information (in the manner described in subparagraph (2) of this paragraph) concerning a change in the taxpayer's residence, if a notice of such lien is also filed in accordance with section 6323(f)(1)(A)(ii) in the State in which such new residence is located (or, if such new residence is located without the United States, in the District of Columbia).

A notice of lien is considered as refiled in the office in which the prior notice or refiled notice was filed under the provisions of section 6323 if it is refiled in the office which, pursuant to a change in the applicable local law, assumed the functions of the office in which the prior notice or refiled notice was filed. If on or before the 90th day referred to in subdivision (ii) more than one written notice is received concerning a change in the taxpayer's residence, a notice of lien is required by this subdivision to be filed only with respect to the residence shown on the written notice received on the most recent date. Subdivision (ii) is applicable regardless of whether the taxpayer resides at the new residence on the date the refiling of notice of lien under subdivision (i) of this subparagraph is completed.

(2) *Notice of change of taxpayer's residence*—(i) *In general.* Except as provided in subdivision (ii) or (iii) of this subparagraph, for purposes of this section, a notice of change of a taxpayer's residence will be effective only if it (A) is received, in writing, from the taxpayer or his representative by the district director or the service center director having jurisdiction where the original notice of lien was filed, (B) relates to an unpaid tax liability of the taxpayer, and (C) states the taxpayer's name and the address of his new residence. Although it is not necessary that a written notice contain the taxpayer's identifying number authorized by section 6109, it is preferable that it include such number. For purposes of this subdivision, a notice of change of a taxpayer's residence shown on a return or an amended return (including a return of the same tax) will not be effective to notify the Internal Revenue Service.

(ii) *Notice received before August 23, 1976.* For purposes of this section, a notice of a change of a taxpayer's residence will also be effective if it (A) is received, in writing, by any office of the Internal Revenue Service before August 23, 1976, from the taxpayer or his representative, (B) relates to an unpaid tax liability of the taxpayer, and (C) states the taxpayer's name and the address of his new residence.

(iii) *By return or amended return.* For purposes of this section, in the case of a notice of lien which relates to an assessment of tax made after December 31, 1966, a notice of change of a taxpayer's residence will also be effective if it is contained in a return or amended return of the same type of tax filed with the Internal Revenue Service by the taxpayer or his representative which on its face indicates that there is a change in the taxpayer's address and correctly states the taxpayer's name, the address of his new residence, and his identifying number required by section 6109.

(iv) *Other rules applicable.* Except as provided in subdivisions (i), (ii), and (iii) of this subparagraph, no communication (either written or oral)

to the Internal Revenue Service will be considered effective as notice of a change of a taxpayer's residence under this section, whether or not the Service has actual notice or knowledge of the taxpayer's new residence. For the purpose of determining the date on which a notice of change of a taxpayer's residence is received under this section, the notice shall be treated as received on the date it is actually received by the Internal Revenue Service without reference to the provisions of section 7502.

(3) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). A, a delinquent taxpayer, is a resident of State M and owns real property in State N. In accordance with § 301.6323(f)-1, notices of lien are filed in States M and N. In order to continue the effect of the notice of lien filed in M, the Internal Revenue Service must refile, during the required refiling period, the notice of lien with the appropriate office in M but is not required to refile the notice of lien with the appropriate office in N. Similarly, in order to continue the effect of the notice of lien filed in State N, the Internal Revenue Service must refile, during the required refiling period, the notice of lien with the appropriate office in N but is not required to refile the notice of lien with the appropriate office in M.

Example (2). B, a delinquent taxpayer, is a resident of State M. In accordance with § 301.6323(f)-1, notice of lien is properly filed in that State. One year before the beginning of the required refiling period, B establishes his residence in State N, and B immediately notifies the Internal Revenue Service of his change in residence in accordance with the provisions of paragraph (b)(2) of this section. In order to continue the effect of the notice of lien filed in M, the Internal Revenue Service must refile, during the required refiling period, notices of lien with (i) the appropriate office in M, and (ii) the appropriate office in N, because B properly notified the Internal Revenue Service of his change in residence to N more than 89 days prior to the date refiling of the notice of lien in M is completed. Even if the Internal Revenue Service had acquired actual notice or knowledge of B's change in residence by other means, if B had not properly notified the Internal Revenue Service of his change in residence, the effect of the notice of lien in State M could have been continued without any refiling in State N.

Example (3). C, a delinquent taxpayer, is a resident of State O. In accordance with § 301.6323(f)-1, notice of lien is properly filed in that State. Four years before the required refiling period, C establishes his residence in State P, and C immediately notifies the Internal Revenue Service of his change in residence in accordance with the provisions of paragraph (b)(2) of this section. Three years before the required refiling period, C establishes his residence in State R, and again C immediately notifies the Internal Revenue Service of his change in residence in accordance with the provisions of paragraph (2) of this section. In order to continue the effect of the notice of lien filed in O, the Internal Revenue Service must refile, during the required refiling period, notices of lien with (i) the appropriate office in O, and (ii) the appropriate office in R. Refiling in R is required because the notice received by the Service of C's change in residence to R was the most recent notice received more than 89 days prior to the date refiling in O is completed. The notice of lien is not required to be filed in P, even though C properly notified the Internal Revenue Service of his change in residence to P, because such notice is not the most recent one received.

Example (4). Assume the same facts as in example (3), except that C does not notify the Internal Revenue Service of his change in residence to R in accordance with the provisions of paragraph (b)(2) of this section. In order to continue the effect of the notice of lien filed in O, the Internal Revenue Service must refile, during the required refiling period, the notice of lien with (i) the appropriate office in O, and (ii) the appropriate office in P. Refiling in P is required because C properly notified the Internal Revenue Service of his change in residence to P, even though C is not a resident of P on the date refiling of the notice of lien in O is completed. The Internal Revenue Service is not required to file a notice of lien in R because C did not properly notify the Service of his change in residence to R.

Example (5). D, a delinquent taxpayer, is a resident of State M and owns real property in States N and O. In accordance with § 301.6323(f)-1, the Internal Revenue Service files notices of lien in M, N, and O States. Five years and 6 months after the date of the assessment shown on the notice of lien, D establishes his residence in P, and at that time the Internal Revenue Service received from D a notification of his change in residence in accordance with the provisions of paragraph (b)(2) of this section. On a date which is 5 years and 7 months after the date of the assessment shown on the notice of lien, the Internal Revenue Service properly refiles notices of lien in M, N, and O which refilings are sufficient to continue the effect of each of the notices of lien. The Internal Revenue Service is not required to file a notice of lien in P because D did not notify the Internal Revenue Service of his change of residence to P more than 89 days prior to the date each of the refilings in M, N, and O was completed.

Example (6). Assume the same facts as in example (5) except that the refiling of the notice of lien in O occurs 100 days after D notifies the Internal Revenue Service of his change in residence to P in accordance with the provisions of paragraph (b)(2) of this section. In order to continue the effect of the notice of lien filed in O, in addition to refiling the notice of lien in O, the Internal Revenue Service must also refile, during the required refiling period, a notice of lien in P because D properly notified the Internal Revenue Service of his change of residence to P more than 89 days prior to the date the refiling in O was completed. However, the Internal Revenue Service is not required to refile the notice of lien in P to maintain the effect of the notices of lien in M and N because D did not notify the Internal Revenue Service of his change in residence to P more than 89 days prior to the date the refilings in M and N were completed.

Example (7). E, a delinquent taxpayer, is a resident of State T. Because T has not designated one office in the case of personal property for filing notices of lien in accordance with the provisions of section 6323(f)(1)(A)(ii), the Internal Revenue Service properly files a notice of lien with the clerk of the appropriate United States district court. However, solely as a matter of convenience for those who may have occasion to search for notices of lien, and not as a matter of legal effectiveness, the Internal Revenue Service also files notice of lien with the recorder of deeds of the county in T where E resides. In addition, the Internal Revenue Service sends a copy of the notice of lien to the X Life Insurance Company to give the Company actual notice of the notice of lien. In order to continue the effect of the notice of lien, the Internal Revenue Service must refile the notice of lien with the clerk of the appropriate United States district court during the required refiling period. In order to continue the effect of the notice of the lien, it is not necessary to refile the notice of lien with the recorder of deeds of the county where E resides, because the refiling of the notice of lien with the recorder of deeds does not constitute a proper filing for the purposes of section 6323(f). In addition, to continue the effect of the notice of lien under this section it is not necessary to send a copy of the notice of lien to the X Life Insurance Company, because the sending of a notice of lien to an insurance company does not constitute a proper filing for the purpose of section 6323(f).

(c) *Required refiling period*—(1) *In general.* For the purposes of this section, except as provided in subparagraph (2) of this paragraph, the term "required refiling period" means—

(i) The 1-year period ending 30

days after the expiration of 6 years after the date of the assessment of the tax, and

(ii) The 1-year period ending with the expiration of 6 years after the close of the preceding required refiling period for such notice of lien.

(2) *Tax assessments made before January 1, 1962.* If the assessment of the tax is made before January 1, 1962, the first required refiling period shall be the calendar year 1967. Thus, to maintain the effectiveness of any notice of lien on file which relates to a lien which arose before January 1, 1962, the Internal Revenue Service will refile the notice of lien during the calendar year 1967.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). On March 1, 1963, an assessment of tax is made against B, a delinquent taxpayer, and a lien for the amount of the assessment arises on that date. On July 1, 1963, in accordance with § 301.6323(f)-1, a notice of lien is filed. The notice of lien filed on July 1, 1963, is effective through March 31, 1969. The first required refiling period for the notice of lien begins on April 1, 1968, and ends on March 31, 1969. A refiling of the notice of lien during that period will extend the effectiveness of the notice of lien filed on July 1, 1963 through March 31, 1975. The second required refiling period for the notice of lien begins on April 1, 1974, and ends on March 31, 1975.

Example (2). Assume the same facts as in example (1), except that although the Internal Revenue Service fails to refile a notice of lien during the first required refiling period (April 1, 1968, through March 31, 1969), a notice of lien is filed on June 2, 1971 in accordance with § 301.6323(f)-1. Because of this filing, the notice of lien filed on June 2, 1971, is effective as of June 2, 1971. That notice must be refiled during the 1-year period ending on March 31, 1975, if it is to continue in effect after March 31, 1975.

Example (3). On April 1, 1960, an assessment of tax is made against B, a delinquent taxpayer, and a tax lien for the amount of the assessment arises on that date. On June 1, 1962, in accordance with § 301.6323(f)-1, a notice of lien is filed. Because the assessment of tax was made before January 1, 1962, the notice of lien filed on June 1, 1962, is effective through December 31, 1967. The first required refiling period for the notice of lien is the calendar year 1967. A refiling of the notice of lien during 1967 will extend the effectiveness of the notice of lien filed on June 1, 1962, through December 31, 1973.

§ 301.6323(h) Statutory provisions; validity and priority against certain persons; definitions.

Sec. 6323. *Validity and priority against certain persons.* * * *

(h) *Definitions.* For purposes of this section and section 6324—

(1) *Security interest.* The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.

(2) *Mechanic's lienor.* The term "mechanic's lienor" means any person who under local law has a lien on real property (or on the proceeds of a contract relating to real property) for services, labor, or materials furnished in conection with the construction or improvement of such property. For purposes of the preceding sentence, a person has a lien on the earliest date such lien becomes valid under local law against subsequent purchasers without actual notice, but not before he begins to furnish the services, labor, or materials.

(3) *Motor vehicle.* The term "motor vehicle" means a self-propelled vehicle which is registered for highway use under the laws of any State or foreign country.

(4) *Security.* The term "security" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form, share of stock, voting trust certificate, or any certificate of interest or participation in, certificate of deposit or receipt for, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

(5) *Tax lien filing.* The term "tax lien filing" means the filing of notice (referred to in subsection (a)) of the lien imposed by section 6321.

(6) *Purchaser.* The term "purchaser" means a person who, for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice. In applying the preceding sentence for purposes of subsection (a) of this section, and for purposes of section 6324—

(A) A lease of property,

(B) A written executory contract to purchase or lease property,

(C) An option to purchase or lease property or any interest therein, or

(D) An option to renew or extend a lease of property,

which is not a lien or security interest shall be treated as an interest in property.

[Sec. 6323(h) as added by sec. 101(a), Federal Tax Lien Act 1966 (80 Stat. 1125) [Pub. L. 89-719, 1966-2 C.B. 623]]

§ 301.6323(h)-0 Scope of Definitions.

Except as otherwise provided by § 301.6323(h)-1, the definitions provided by § 301.6323(h)-1 apply for purposes of §§ 301.6323(a)-1 through 301.6324-1.

§ 301.6323(h)-1 Definitions.

(a) *Security interest*—(1) *In general.* The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time—

(i) If, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien (as provided in subparagraph (2) of this paragraph) arising out of an unsecured obligation; and

(ii) To the extent that, at such time, the holder has parted with money or money's worth (as defined in subparagraph (3) of this paragraph).

For purposes of this subparagraph, a contract right (as defined in paragraph (c)(2)(i) of § 301.6323(c)-1) is in existence when the contract is made. An account receivable (as defined in paragraph (c)(2)(ii) of § 301.6323(c)-1) is in existence when, and to the extent, a right to payment is earned by performance. A security interest must be in existence, within the meaning of this paragraph, at the time as of which its priority against a tax lien is determined. For example, to be afforded priority under the provisions of paragraph (a) of §301.6323(a)-1 a security interest must be in existence within the meaning of this paragraph before a notice of lien is filed.

(2) *Protection against a subsequent judgment lien.* (i) For purposes of this paragraph, a security interest is deemed to be protected against a subsequent judgment lien on—

(*a*) The date on which all actions required under local law to establish the priority of a security interest against a judgment lien have been taken, or

(*b*) If later, the date on which all required actions are deemed effective, under local law, to establish the priority of the security interest against a judgment lien.

For purposes of this subdivision, the dates described in (*a*) and (*b*) of this subdivision (i) shall be determined without regard to any rule or principle of local law which permits the relation back of any requisite action to a date earlier than the date on which the action is actually performed. For purposes of this paragraph, a judgment lien is a lien held by a judgment lien creditor as defined in paragraph (g) of this section.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. (i) Under the law of State X, a security interest in negotiable instruments, stocks, bonds or other securities may be perfected, and hence protected against a judgment lien, only by the secured party taking possession of the instruments or securities. However, a security interest in such intangible personal property is considered to be temporarily perfected for a period of 21 days from the time the security interest attaches, to the extent consideration other than past consideration is given under a written security agreement. Under the law of X, a security interest attaches to such collateral when there is an agreement between the creditor and debtor that the interest attaches, the debtor has rights in the property, and consideration is given by the creditor. Under the law of X, in the case of temporary perfection, the security interest in such property is protected during the 21-day period against a judgment lien arising, after the security interest attaches, out of an unsecured obligation. Upon expiration of the 21-day period, the holder of the security interest must take possession of the collateral to continue perfection.

(ii) Because the security interest is protected during the 21-day period against a subsequent judgment lien arising out of an unsecured obligation, and because the taking of possession before the conclusion of the period of temporary perfection is not considered, for purposes of subdivision (i) of this subparagraph, to be a requisite action which relates back to the beginning of such period, the requirements of this paragraph are satisfied. However, because taking possession is a condition precedent to continued perfection, possession of the collateral is a requisite action to establish such priority after expiration of the period of temporary perfection. If there is a lapse of perfection for failure to take possession, the determination of when the security interest exists (for purposes of protection against the tax lien) is made without regard to the period of temporary perfection.

(3) *Money or money's worth.* For purposes of this paragraph, the term "money or money's worth" includes money, a security (as defined in paragraph (d) of this section), tangible or intangible property, services, and other consideration reducible to a money value. Money or money's worth also includes any consideration which otherwise would constitute money or money's worth under the preceding sentence which was parted with before the security interest would otherwise exist if, under local law, past consideration is sufficient to support an agreement giving rise to a security interest. A relinquishing or promised relinquishment of dower, curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights is not a consideration in money or money's worth. Nor is love and affection, promise of marriage, or any other consideration not reducible to a money value a consideration in money or money's worth.

(4) *Holder of a security interest.* For purposes of this paragraph, the holder of a security interest is the person in whose favor there is a security interest. For provisions relating to the treatment of a purchaser of commercial financing security as a holder of a security interest, see § 301.6323(c)-1(e).

(b) *Mechanic's lienor*—(1) *In general.* The term "mechanic's lienor" means any person who under local law has a lien on real property (or on the proceeds of a contract relating to real property) for services, labor, or materials furnished in connection with the construction or improvement (including demolition) of the property. A mechanic's lienor is treated as having a lien on the later of—

(i) The date on which the mechanic's lien first becomes valid under local law against subsequent purchasers of the real property without actual notice, or

(ii) The date on which the mechanic's lienor begins to furnish the services, labor, or materials.

(2) *Examples.* The provisions of this paragraph may be illustrated by the following example:

Example (1). On February 1, 1968, A lets a contract for the construction of an office building on property owned by him. On March 1, 1968, in accordance with § 301.6323(f)-1, a notice of lien for delinquent Federal taxes owed by A is filed. On April 1, 1968, B, a lumber dealer, delivers lumber to A's property. On May 1, 1968, B records a mechanic's lien against the property to secure payment of the price of the lumber. Under local law, B's mechanic's lien is valid against subsequent purchasers of real property without notice from February 1, 1968, which is the date the construction contract was entered into. Because the date on which B's mechanic's lien is valid under local law against subsequent purchasers is February 1, and the date on which B begins to furnish the materials is April 1, the date on which B becomes a mechanic's lienor within the meaning of this paragraph is April 1, the later of these two dates. Under paragraph (a) of § 301.6323(a)-1, B's mechanic's lien will not have priority over the Federal tax lien, even though under local law the mechanic's lien relates back to the date of the contract.

(c) *Motor vehicle.* (1) The term "motor vehicle" means a self-propelled vehicle which is registered for highway use under the laws of any State, the District of Columbia, or a foreign country.

(2) A motor vehicle is "registered for highway use" at the time of a sale if immediately prior to the sale it is so registered under the laws of any State, the District of Columbia, or a foreign country. Where immediately prior to the sale of a motor vehicle by a dealer, the dealer is permitted under local law to operate it under a dealer's tag, license, or permit issued

to him, the motor vehicle is considered to be registered for highway use in the name of the dealer at the time of the sale.

(d) *Security.* The term "security" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form, share of stock, voting trust certificate, or any certificate of interest or participation in, certificate of deposit or receipt for, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

(e) *Tax lien filing.* The term "tax lien filing" means the filing of notice of the lien imposed by section 6321 in accordance with § 301.6323(f)-1.

(f) *Purchaser*—(1) *In general.* The term "purchaser" means a person who, for adequate and full consideration in money or money's worth (as defined in subparagraph (3) of this paragraph), acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice.

(2) *Interest in property.* For purposes of this paragraph, each of the following interests is treated as an interest in property, if it is not a lien or security interest:

(i) A lease of property,

(ii) A written executory contract to purchase or lease property,

(iii) An option to purchase or lease property and any interest therein, or

(iv) An option to renew or extend a lease of property.

(3) *Adequate and full consideration in money or money's worth.* For purposes of this paragraph, the term "adequate and full consideration in money or money's worth" means a consideration in money or money's worth having a reasonable relationship to the true value of the interest in property acquired. See paragraph (a)(3) of this section for definition of the term "money or money's worth." Adequate and full consideration in money or money's worth may include the consideration in a bona fide bargain purchase. The term also includes the consideration in a transaction in which the purchaser has not completed performance of his obligation, such as the consideration in an installment purchase contract, even though the purchaser has not completed the installment payments.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). A enters into a contract for the purchase of a house and lot from B. Under the terms of the contract A makes a down payment and is to pay the balance of the purchase price in 120 monthly installments. After payment of the last installment, A is to receive a deed to the property. A enters into possession, which under local law protects his interest in the property against subsequent purchasers without actual notice. After A has paid five monthly installments, a notice of lien for Federal taxes is filed against B in accordance with § 301.6323(f)-1. Because the contract is an executory contract to purchase property and is valid under local law against subsequent purchasers without actual notice, A qualifies as a purchaser under this paragraph.

Example (2). C owns a residence which he leases to his son-in-law, D, for a period of 5 years commencing January 1, 1968. The lease provides for payment of $100 a year, although the fair rental value of the residence is $2,500 a year. The lease is recorded on December 31, 1967. On March 1, 1968, a notice of tax lien for unpaid Federal taxes of C is filed in accordance with § 301.6323(f)-1. Under local law, D's interest is protected against subsequent purchasers without actual notice. However, because the rental paid by D has no reasonable relationship to the value of the interest in property acquired, D does not qualify as a purchaser under this paragraph.

(g) *Judgment lien creditor.* The term "judgment lien creditor" means a person who has obtained a valid judgment, in a court of record and of competent jurisdiction, for the recovery of specifically designated property or for a certain sum of money. In the case of a judgment for the recovery of a certain sum of money, a judgment lien creditor is a person who has perfected a lien under the judgment on the property involved. A judgment lien is not perfected until the identity of the lienor, the property subject to the lien, and the amount of the lien are established. Accordingly, a judgment lien does not include an attachment or garnishment lien until the lien has ripened into judgment, even though under local law the lien of the judgment relates to an earlier date. If recording or docketing is necessary under local law before a judgment becomes effective against third parties acquiring liens on real property, a judgment lien under such local law is not perfected with respect to real property until the time of such recordation or docketing. If under local law levy or seizure is necessary before a judgment lien becomes effective against third parties acquiring liens on personal property, then a judgment lien under such local law is not perfected until levy or seizure of the personal property involved. The term "judgment" does not include the determination of a quasi-judicial body or of an individual acting in a quasi-judicial capacity such as the action of State taxing authorities.

§ 301.6323(i) Statutory provisions; validity and priority against certain persons; special rules.

Sec. 6323. *Validity and priority against certain persons.* * * *

(i) *Special rules*—(1) *Actual notice or knowledge.* For purposes of this subchapter, an organization shall be deemed for purposes of a particular transaction to have actual notice or knowledge of any fact from the time such fact is brought to the attention of the individual conducting such transaction, and in any event from the time such fact would have been brought to such individual's attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

(2) *Subrogation.* Where, under local law, person is subrogated to the rights of another with respect to a lien or interest, such person shall be subrogated to such

rights for purposes of any lien imposed by section 6321 or 6324.

(3) *Disclosure of amount of outstanding lien.* If a notice of lien has been filed pursuant to subsection (f), the Secretary or his delegate is authorized to provide by regulations the extent to which, and the conditions under which, information as to the amount of the outstanding obligation secured by the lien may be disclosed.

[Sec. 6323(i) as added by sec. 101(a), Federal Tax Lien Act 1966 (80 Stat. 1125) [Pub. L. 89-719, 1966-2 C.B. 623]]

§ 301.6323(i)-1 Special rules.

(a) *Actual notice or knowledge.* For purposes of subchapter C (section 6321 and following), chapter 64 of the Code, an organization is deemed, in any transaction, to have actual notice or knowledge of any fact from the time the fact is brought to the attention of the individual conducting the transaction, and in any event from the time the fact would have been brought to the individual's attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

(b) *Subrogation*—(1) *In general.* Where, under local law, one person is subrogated to the rights of another with respect to a lien or interest, such person shall be subrogated to such rights for purposes of any lien imposed by section 6321 or 6324. Thus, if a tax lien imposed by section 6321 or 6324 is not valid with respect to a particular interest as against the holder of that interest, then the tax lien also is not valid with respect to that interest as against any person who, under local law, is a successor in interest to the holder of that interest.

(2) *Example.* The application of this paragraph may be illustrated by the following example:

Example. On February 1, 1968, an assessment is made and a tax lien arises with respect to A's delinquent tax liability. On February 25, 1968, in accordance with § 301.6323(f)-1, a notice of lien is properly filed. On March 1, 1968, A negotiates a loan from B, the security for which is a second mortgage on property owned by A. The first mortgage on the property is held by C and has priority over the tax lien. Upon default by A, C begins proceedings to foreclose upon the first mortgage. On September 1, 1968, B pays the amount of principal and interest in default to C in order to protect the second mortgage against the pending foreclosure of C's senior mortgage. Under local law, B is subrogated to C's rights to the extent of the payment to C. Therefore, the tax lien is invalid against B to the extent he became subrogated to C's rights even though the tax lien is valid against B's second mortgage on the property.

(c) *Disclosure of amount of outstanding lien.* If a notice of lien has been filed (see § 301.6323(f)-1), the amount of the outstanding obligation secured by the lien is authorized to be disclosed as a matter of public record on Form 668 "Notice of Federal Tax Lien under Internal Revenue Laws". The amount of the outstanding obligation secured by the lien remaining unpaid at the time of an inquiry is authorized to be disclosed to any person who has a proper interest in determining this amount. Any person who has a right in the property or intends to obtain a right in the property by purchase or otherwise will, upon presentation by him of satisfactory evidence, be considered to have a proper interest. Any person desiring this information may make his request to the office of the Internal Revenue Service named on the notice of lien with respect to which the request is made. The request should clearly describe the property subject to the lien, identify the applicable lien, and give the reasons for requesting the information.

Par. 8. Section 301.6325 is amended to read as follows:

§ 301.6325 Statutory provisions; release of lien or discharge of property.

Sec. 6325. *Release of lien or discharge of property*—(a) *Release of lien.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of release of any lien imposed with respect to any internal revenue tax if—

(1) *Liability satisfied or unenforceable.* The Secretary or his delegate finds that the liability for the amount assessed, together with all interest in respect thereof, has been fully satisfied or has become legally unenforceable; or

(2) *Bond accepted.* There is furnished to the Secretary or his delegate and accepted by him a bond that is conditioned upon the payment of the amount assessed, together with all interest in respect thereof, within the time prescribed by law (including any extension of such time), and that is in accordance with such requirements relating to terms, conditions, and form of the bond and sureties thereon, as may be specified by such regulations.

(b) *Discharge of property*—(1) *Property double the amount of the liability.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of discharge of any part of the property subject to any lien imposed under this chapter if the Secretary or his delegate finds that the fair market value of that part of such property remaining subject to the lien is at least double the amount of the unsatisfied liability secured by such lien and the amount of all other liens upon such property which have priority over such lien.

(2) *Part payment; interest of United States valueless.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of discharge of any part of the property subject to the lien if—

(A) There is paid over to the Secretary or his delegate in partial satisfaction of the liability secured by the lien an amount determined by the Secretary or his delegate, which shall not be less than the value, as determined by the Secretary or his delegate, of the interest of the United States in the part to be so discharged, or

(B) The Secretary or his delegate determines at any time that the interest of the United States in the part to be so discharged has no value.

In determining the value of the interest of the United States in the part to be so discharged, the Secretary or his delegate shall give consideration to the value of such part and to such liens thereon as have priority over the lien of the United States.

(3) *Substitution of proceeds of sale.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of discharge of any part of the property subject to the lien if such part of the property is sold and, pursuant to an agreement with

the Secretary or his delegate, the proceeds of such sale are to be held, as a fund subject to the liens and claims of the United States, in the same manner and with the same priority as such liens and claims had with respect to the discharged property.

(c) *Estate or gift tax.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of discharge of any or all of the property subject to any lien imposed by section 6324 if the Secretary or his delegate finds that the liability secured by such lien has been fully satisfied or provided for.

(d) *Subordination of lien.* Subject to such regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of subordination of any lien imposed by this chapter upon any part of the property subject to such lien if—

(1) There is paid over to the Secretary or his delegate an amount equal to the amount of the lien or interest to which the certificate subordinates the lien of the United States, or

(2) The Secretary or his delegate believes that the amount realizable by the United States from the property to which the certificate relates, or from any other property subject to the lien, will ultimately be increased by reason of the issuance of such certificate and that the ultimate collection of the tax liability will be facilitated by such subordination.

(e) *Nonattachment of lien.* If the Secretary or his delegate determines that, because of confusion of names or otherwise, any person (other than the person against whom the tax was assessed) is or may be injured by the appearance that a notice of lien filed under section 6323 refers to such person, the Secretary or his delegate may issue a certificate that the lien does not attach to the property of such person.

(f) *Effect of certificate*—(1) *Conclusiveness.* Except as provided in paragraphs (2) and (3), if a certificate is issued pursuant to this section by the Secretary or his delegate and is filed in the same office as the notice of lien to which it relates (if such notice of lien has been filed) such certificate shall have the following effect:

(A) In the case of a certificate of release, such certificate shall be conclusive that the lien referred to in such certificate is extinguished;

(B) In the case of a certificate of discharge, such certificate shall be conclusive that the property covered by such certificate is discharged from the lien;

(C) In the case of a certificate of subordination, such certificate shall be conclusive that the lien or interest to which the lien of the United States is subordinated is superior to the lien of the United States; and

(D) In the case of a certificate of nonattachment, such certificate shall be conclusive that the lien of the United States does not attach to the property of the person referred to in such certificate.

(2) *Revocation of certificate of release or nonattachment.* If the Secretary or his delegate determines that a certificate of release or nonattachment of a lien imposed by section 6321 was issued erroneously or improvidently, or if a certificate of release of such lien was issued pursuant to a collateral agreement entered into in connection with a compromise under section 7122 which has been breached, and if the period of limitation on collection after assessment has not expired, the Secretary or his delegate may revoke such certificate and reinstate the lien—

(A) By mailing notice of such revocation to the person against whom the tax was assessed at his last known address, and

(B) By filing notice of such revocation in the same office in which the notice of lien to which it relates was filed (if such notice of lien had been filed).

Such reinstated lien (i) shall be effective on the date notice of revocation is mailed to the taxpayer in accordance with the provisions of subparagraph (A), but not earlier than the date on which any required filing of notice of revocation is filed in accordance with the provisions of subparagraph (B), and (ii) shall have the same force and effect (as of such date), until the expiration of the period of limitation on collection after assessment, as a lien imposed by section 6321 (relating to lien for taxes).

(3) *Certificates void under certain conditions.* Notwithstanding any other provision of this subtitle, any lien imposed by this chapter shall attach to any property with respect to which a certificate of discharge has been issued if the person liable for the tax reacquires such property after such certificate has been issued.

(g) *Filing of certificates and notices.* If a certificate or notice issued pursuant to this section may not be filed in the office designated by State law in which the notice of lien imposed by section 6321 is filed, such certificate or notice shall be effective if filed in the office of the clerk of the United States district court for the judicial district in which such office is situated.

(h) *Cross reference.* For provisions relating to bonds, see chapter 73 (sec. 7101 and following).

[Sec. 6325 as amended by sec. 77, Technical Amendments Act 1958 (72 Stat. 1662) [Pub. L. 85-866, 1958-3 C.B. 254]; sec. 103(a), Federal Tax Lien Act 1966 (80 Stat. 1133) [Pub. L. 89-719, 1966-2 C.B. 623]]

Par. 9. Section 301.6325-1 is amended by revising the heading, by revising subparagraphs (1)(i), (2), (3), and (4) of paragraph (b), by revising paragraph (d), and by adding new paragraphs (e), (f), and (g). These revised and added provisions read as follows:

§ 301.6325-1 Release of lien or discharge of property.

* * * * *

(b) *Discharge of specific property from the lien*—(1) *Property double the amount of the liability.* (i) The district director may, in his discretion, issue a certificate of discharge of any part of the property subject to a lien imposed under chapter 64 of the Code if he determines that the fair market value of that part of the property remaining subject to the lien is at least double the sum of the amount of the unsatisfied liability secured by the lien and of the amount of all other liens upon the property which have priority over the lien. In general, fair market value is that amount which one ready and willing but not compelled to buy would pay to another ready and willing but not compelled to sell the property.

* * * * *

(2) *Part payment; interest of United States valueless*—(i) *Part payment.* The district director may, in his discretion, issue a certificate of discharge of any part of the property subject to a lien imposed under chapter 64 of the Code if there is paid over to him in partial satisfaction of the liability secured by the lien an amount determined by him to be not less than the value of the interest of the United States in the property to be so discharged. In determining the amount to be paid, the district director will take into consideration all the facts and circumstances of the case, including the expenses to which the Government has been put in the matter. In no case shall the amount to be paid be less than the value of the interest of the United States in the property with respect to which the certificate of discharge is to be issued.

(ii) *Interest of the United States valueless.* The district director may, in his discretion, issue a certificate of discharge of any part of the property subject to the lien if he determines

that the interest of the United States in the property to be so discharged has no value.

(iii) *Valuation of interest of United States.* For purposes of this subparagraph, in determining the value of the interest of the United States in the property, or any part thereof, with respect to which the certificate of discharge is to be issued, the district director shall give consideration to the value of the property and the amount of all liens and encumbrances thereon having priority over the Federal tax lien. In determining the value of the property, the district director may, in his discretion, give consideration to the forced sale value of the property in appropriate cases.

(3) *Discharge of property by substitution of proceeds of sale.* A district director may, in his discretion, issue a certificate of discharge of any part of the property subject to a lien imposed under chapter 64 of the Code if such part of the property is sold and, pursuant to a written agreement with the district director, the proceeds of the sale and held, as a fund subject to the liens and claims of the United States, in the same manner and with the same priority as the lien or claim had with respect to the discharged property. This subparagraph does not apply unless the sale divests the taxpayer of all right, title, and interest in the property sought to be discharged. Any reasonable and necessary expenses incurred in connection with the sale of the property and the administration of the sale proceeds shall be paid by the applicant or from the proceeds of the sale before satisfaction of any lien or claim of the United States.

(4) *Application for certificate of discharge.* Any person desiring a certificate of discharge under this paragraph shall submit an application in writing to the district director responsible for collection of the tax. The application shall contain such information as the district director may require.

* * * * *

(d) *Subordination of lien*—(1) *By payment of the amount subordinated.* A district director may, in his discretion, issue a certificate of subordination of a lien imposed under chapter 64 of the Code upon any part of the property subject to the lien if there is paid over to the district director an amount equal to the amount of the lien or interest to which the certificate subordinates the lien of the United States. For this purpose, the tax lien may be subordinated to another lien of interest on a dollar-for-dollar basis. For example, if a notice of a Federal tax lien is filed and a delinquent taxpayer secures a mortgage loan on a part of the property subject to the tax lien and pays over the proceeds of the loan to a district director after an application for a certificate of subordination is approved, the district director will issue a certificate of subordination. This certificate will have the effect of subordinating the tax lien to the mortgage.

(2) *To facilitate tax collection*—(i) *In general.* A district director may, in his discretion, issue a certificate of subordination of a lien imposed under chapter 64 of the Code upon any part of the property subject to the lien if the district director believes that the subordination of the lien will ultimately result in an increase in the amount realized by the United States from the property subject to the lien and will facilitate the ultimate collection of the tax liability.

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A, a farmer, needs money in order to harvest his crop, A Federal tax lien, notice of which has been filed, is outstanding with respect to A's property. B, a lending institution is willing to make the necessary loan if the loan is secured by a first mortgage on the farm which is prior to the Federal tax lien. Upon examination, the district director believes that ultimately the amount realizable from A's property will be increased and the collection of the tax liability will be facilitated by the availability of cash when the crop is harvested and sold. In this case, the district director may, in his discretion, subordinate the tax lien on the farm to the mortgage securing the crop harvesting loan.

Example (2). C owns a commercial building which is deteriorating and in unsalable condition. Because of outstanding federal tax liens, notices of which have been filed, C is unable to finance the repair and rehabilitation of the building. D, a contractor, is willing to do the work if his mechanic's lien on the property is superior to the federal tax liens. Upon examination, the district director believes that ultimately the amount realizable from C's property will be increased and the collection of the tax liability will be facilitated by arresting deterioration of the property and restoring it to salable condition. In this case, the district director may, in his discretion, subordinate the tax lien on the building to the mechanic's lien.

Example (3). E, a manufacturer of electronic equipment, obtains financing from F, a lending institution, pursuant to a security agreement, with respect to which a financing statement was duly filed under the Uniform Commercial Code on June 1, 1970. On April 15, 1971, F gains actual notice or knowledge that notice of a federal tax lien had been filed against E on March 31, 1971, and F refuses to make further advances unless its security interest is assured of priority over the federal tax lien. Upon examination, the district director believes that ultimately the amount realizable from E's property will be increased and the collection of the tax liability will be facilitated if the work in process can be completed and the equipment sold. In this case, the district director may, in his discretion, subordinate the tax lien to F's security interest for the further advances required to complete the work.

Example (4). Suit is brought against G by H, who claims ownership of property the legal title to which is held by G. A federal tax lien against G, notice of which has previously been filed, will be enforceable against the property if G's title is confirmed. Because section 6323(b)(8) is inapplicable, J, an attorney, is unwilling to defend the case for G unless he is granted a contractual lien on the property, superior to the federal tax lien. Upon examination, the district director believes that the successful defense of the case by G will increase the amount ultimately realizable from G's property and will facilitate collection of the tax liability. In this case, the district director may, in his discretion, subordinate the tax lien to J's contractual lien on the disputed property to secure J's reasonable fees and expenses.

(3) *Application for certificate of subordination.* Any person desiring a certificate of subordination under this paragraph shall submit an application therefor in writing to the district director responsible for the collection of the tax. The application shall contain such

information as the district director may require.

(e) *Nonattachment of lien.* If a district director determines that, because of confusion of names or otherwise, any person (other than the person against whom the tax was assessed) is or may be injured by the appearance that a notice of lien filed in accordance with § 301.6323(f)-1 refers to such person, the district director may issue a certificate of nonattachment. Such certificate shall state that the lien, notice of which has been filed, does not attach to the property of such person. Any person desiring a certificate of nonattachment under this paragraph shall submit an application therefor in writing to the district director responsible for the collection of the tax. The application shall contain such information as the district director may require.

(f) *Effect of certificate*—(1) *Conclusiveness.* Except as provided in subparagraphs (2) and (3) of this paragraph, if a certificate is issued under section 6325 by a district director and the certificate is filed in the same office as the notice of lien to which it relates (if the notice of lien has been filed), the certificate shall have the following effect—

(i) In the case of a certificate of release issued under paragraph (a) of this section, the certificate shall be conclusive that the tax lien referred to in the certificate is extinguished;

(ii) In the case of a certificate of discharge issued under paragraph (b) or (c) of this section, the certificate shall be conclusive that the property covered by the certificate is discharged from the tax lien;

(iii) In the case of a certificate of subordination issued under paragraph (d) of this section, the certificate shall be conclusive that the lien or interest to which the Federal tax lien is subordinated is superior to the tax lien; and

(iv) In the case of a certificate of nonattachment issued under paragraph (e), the certificate shall be conclusive that the lien of the United States does not attach to the property of the person referred to in the certificate.

(2) *Revocation of certificate of release or nonattachment*—(i) *In general.* If a district director determines that either—

(*a*) A certificate of release or a certificate of nonattachment of the general tax lien imposed by section 6321 was issued erroneously or improvidently, or

(*b*) A certificate of release of such lien was issued in connection with a compromise agreement under section 7122 which has been breached, and if the period of limitation on collection after assessment of the tax liability has not expired, the district director may revoke the certificate and reinstate the tax lien. The provisions of this subparagraph do not apply in the case of the lien imposed by section 6324 relating to estate and gift taxes.

(ii) *Method of revocation and reinstatement.* The revocation and reinstatement described in subdivision (i) of this subparagraph is accomplished by—

(*a*) Mailing notice of the revocation to the taxpayer at his last known address, and

(*b*) Filing notice of the revocation of the certificate in the same office in which the notice of lien to which it relates was filed (if the notice of lien has been filed).

(iii) *Effect of reinstatement*—(*a*) *Effective date.* A tax lien reinstated in accordance with the provisions of this subparagraph is effective on and after the date the notice of revocation is mailed to the taxpayer in accordance with the provisions of subdivision (ii) (*a*) of this subparagraph, but the reinstated lien is not effective before the filing of notice of revocation, in accordance with the provisions of subparagraph (ii)(*b*) of this subparagraph, if the filing is required by reason of the fact that a notice of the lien had been filed.

(*b*) *Treatment of reinstated lien.* As of the effective date of reinstatement, a reinstated lien has the same force and effect as a general tax lien imposed by section 6321 which arises upon assessment of a tax liability. The reinstated lien continues in existence until the expiration of the period of limitation on collection after assessment of the tax liability to which it relates. The reinstatement of the lien does not retroactively reinstate a previously filed notice of lien. The reinstated lien is not valid against any holder of a lien or interest described in § 301.6323(a)-1 until notice of the reinstated lien has been filed in accordance with the provisions of § 301.6323 (f)-1 subsequent to or concurrent with the time the reinstated lien became effective.

(iv) *Example.* The provisions of this subparagraph may be illustrated by the following example:

Example. On March 1, 1967, an assessment of an unpaid Federal tax liability is made against A. On March 1, 1968, notice of the Federal tax lien, which arose at the time of assessment, is filed. On April 1, 1968, A executes a bona fide mortgage on property belonging to him to B. On May 1, 1968, a certificate of release of the tax lien is erroneously issued and is filed by A in the same office in which the notice of lien was filed. On June 3, 1968, the lien is reinstated in accordance with the provisions of this subparagraph. On July 1, 1968, A executes a bona fide mortgage on property belonging to him to C. On August 1, 1968, a notice of the lien which was reinstated is properly filed in accordance with the provisions of § 301.6323(f)-1. The mortgages of both B and C will have priority over the rights of the United States with respect to the tax liability in question. Because a reinstated lien continues in existence only until the expiration of the period of limitation on collection after assessment of the tax liability to which the lien relates, in the absence of any extension or suspension of the period of limitation on collection after assessment, the reinstated lien will become unenforceable by reason of lapse of time after February 28, 1973.

(3) *Certificates void under certain conditions.* Notwithstanding any other provisions of subtitle F of the Code, any lien for Federal taxes attaches to any property with respect to which a certificate of discharge has been issued if the person liable for the tax reacquires the property after the certificate

has been issued. Thus, if property subject to a Federal tax lien is discharged therefrom and is later reacquired by the delinquent taxpayer at a time when the lien is still in existence, the tax lien attaches to the reacquired property and is enforceable against it as in the case of after-acquired property generally.

(g) *Filing of certificates and notices.* If a certificate or notice described in this section may not be filed in the office designated by State law in which the notice of lien imposed by section 6321 (to which the certificate or notice relates) is filed, the certificate or notice is effective if filed in the office of the clerk of the United States district court for the judicial district in which the State office where the notice of lien is filed is situated.

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; U.S.C. 7805).)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved August 16, 1976

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 20, 1976; 8:45 a.m., published in the issue of the Federal Register for August 23, 1976, 41 F.R. 35490)

Section 6325.—Release of Lien or Discharge of Property

26 CFR 301.6325-1: Release of lien or discharge of property.

Discharge of property from lien. See T.D. 7429, page 396.

Chapter 65.—Abatements, Credits, and Refunds
Subchapter A.—Procedure in General

Section 6402.—Authority to Make Credits or Refunds

26 CFR 301.6402-3: Special rules applicable to income tax.

Whether a claim for refund is timely filed under section 6511(a) of the Code when the taxpayer's return (which is also the claim for refund) is filed more than three years after the due date of the return. See Rev. Rul. 76-511, below.

Chapter 66.—Limitations
Subchapter B.—Limitations on Credit or Refund

Section 6511.—Limitations on Credit or Refund

26 CFR 301.6511(b)-1: Limitations on allowance of credits and refunds.
(Also Sections 6402, 6513; 301.6402-3, 301.6513-1.)

Refund of overpayment; return filed more than three years after due date. The provisions of section 6511(b)(2)(A) of the Code preclude the allowance of a refund to a taxpayer who files an original return reflecting an overpayment, which constitutes a claim for refund under section 6402, later than three years after the due date of the return.

Rev. Rul. 76-511

Advice has been requested whether the refund of an overpayment of income tax is barred under the circumstances described below.

During the calendar year 1972, *A*'s employer withheld Federal income tax from *A*'s wages. On April 30, 1976, *A* filed a 1972 Federal income tax return showing an overpayment of tax. *A* indicated on the return that the overpayment was to be refunded. *A* had not requested an extension of time for filing the return.

Section 6402(a) of the Internal Revenue Code of 1954 provides that, in the case of any overpayment, the Secretary or the Secretary's delegate, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall refund any balance to such person.

Section 301.6402-3(b)(1) of the Regulations on Procedure and Administration provides that a properly executed individual income tax return shall at the election of the taxpayer be a claim for refund within the meaning of sections 6402 and 6511 of the Code for the amount of the overpayment disclosed by such return. For purposes of section 6511, the claim shall be considered as filed on the date on which the return is considered as filed. A return shall be a claim for refund if it contains a statement setting forth the amount determined as an overpayment and advising that such amount shall be refunded to the taxpayer.

Section 6511(a) of the Code provides that a claim for credit or refund of an overpayment of any tax must be filed within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid.

Section 6511(b)(1) of the Code provides that no credit or refund shall be allowed after the expiration of the period of limitation prescribed in section 6511(a), unless a claim therefor is timely filed. Section 6511(b)(2)(A) provides that if the claim was filed within 3 years from the date the return was filed, the amount of the credit or refund shall not exceed the amount of tax paid within the period immediately preceding the filing of the claim, equal to 3 years plus the period of any extension of time for filing the return.

Section 6513(b)(1) of the Code provides that, for the purpose of section 6511, any tax withheld from wages during any calendar year shall, in respect of the wage earner, be deemed to have been paid on the 15th day of the fourth month following the close of the wage earner's taxable year.

In this case, *A* filed a claim for refund within the 3-year period of

limitation prescribed by section 6511 (a) of the Code, because, under section 301.6402-3 of the regulations, *A*'s 1972 income tax return was a claim for refund. However, under the provisions of section 6513(b)(1), the overpayment is deemed to have been made on April 15, 1973, which is not within the 3-year period immediately preceding April 30, 1976, the date the claim was filed. Therefore, although the claim for refund was timely filed, allowance of the refund is specifically barred by the provisions of section 6511(b)(2)(A).

If *A* had filed the 1972 income tax return on April 1, 1976, the refund would have been allowable since the overpayment would have been made within the 3-year period immediately preceding the filing of the claim.

Section 6513.—Time Return Deemed Filed and Tax Considered Paid

26 CFR 301.6513-1: Time return filed and tax considered paid.

Whether a claim for refund is timely filed under section 6511(a) of the Code when the taxpayer's return (which is also the claim for refund) is filed more than three years after the due date of the return. See Rev. Rul. 76-511, page 428.

Chapter 67.—Interest
Subchapter A.—Interest on Underpayments

Section 6601.—Interest on Underpayment, Nonpayment, or Extensions of Time for Payment, of Tax

26 CFR 301.6601-1: Interest on underpayments.
(Also Sections 815, 6072, 6151; 1.815-6, 1.6072-2, 1.6151-1.)

Interest on underpayment; life insurance company. Interest can be imposed on the underpayment resulting from an adjustment required under section 815(d)(2)(A) of the Code for a life insurance company that for two successive years failed to qualify under section 801(a) even though the amount of the underpayment cannot be determined until the results of operations are known for the succeeding two year periods.

Rev. Rul. 76-383

Advice has been requested whether interest is due under section 6601 of the Internal Revenue Code of 1954 on an underpayment of tax that resulted from an adjustment under section 815(d)(2)(A).

Prior to the calendar year 1974, the taxpayer qualified as a life insurance company under section 801(a) of the Code. However, for the years 1974 and 1975 the taxpayer failed to qualify as a life insurance company under section 801(a). Because of this failure an adjustment was required under section 815(d)(2)(A) that resulted in a tax deficiency for the calendar year 1973. In 1976 the taxpayer paid the deficiency including the interest assessed thereon for the period from March 15, 1974, to March 15, 1976, but objected to the payment of such interest on the ground that the 1973 underpayment could not have been determined until the results of operations for the succeeding two year periods were known.

Section 815(d)(2)(A) of the Code provides that if for any two successive taxable years the taxpayer is not a life insurance company, then the amount taken into account in determining taxable income under section 802(b)(3) for the last preceding taxable year for which it was a life insurance company shall be increased by the amount remaining in its policy holders surplus account at the close of such last preceding taxable year.

Section 6072 of the Code provides that a corporation's income tax return made on the basis of a calendar year shall be filed on or before the 15th day of March following the close of the calendar year. In the instant case, the 1973 return was due on March 15, 1974.

Section 6151 of Chapter 62 of the Code provides, subject to exceptions not pertinent to this case, that tax shall be paid at the time and place fixed for filing the return determined without regard to an extension of time.

Section 6601(a) of the Code provides that if the amount of any tax is not paid when due, interest shall be paid on such amount for the period from the date required to be paid to the date paid.

Section 6601(b) of the Code provides that, except as otherwise provided, the last date prescribed for payment of tax shall be determined under chapter 62 (section 6151).

Accordingly, since the payment of interest on an underpayment of tax is mandatory under section 6601 of the Code interest is due from March 15, 1974 to March 15, 1976 on the underpayment of tax for the calendar year 1973 that resulted from an adjustment under section 815(d)(2)(A).

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26 CFR 301.6601-1: Interest on underpayments.
(Also Section 6152; 1.6152-1.)

Interest on deficiencies; overpayment on original return. The interest payable on the income tax deficiency of a corporation that made timely estimated tax payments exceeding its total tax liability for the year in question and received a refund, after having twice obtained extensions of time to file, is computed from the original due date of the return.

Rev. Rul. 76-493

Advice has been requested concerning the computation of interest on a deficiency under the circumstances described below.

X, a calendar year corporation, made timely estimated tax payments during 1974 amounting to $100,000. On March 14, 1975, *X* filed a Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, showing an expected tax liability of $90,000. On June 15, 1975, *X* filed a Form 7005, Application for

Additional Extension of Time to File Corporation Income Tax Return. On September 15, 1975, *X* filed its 1974 Form 1120, U.S. Corporation Income Tax Return, indicating a tax liability of $80,000 and an overpayment of $20,000, that was refunded to *X*. The Internal Revenue Service subsequently audited *X*'s 1974 return and determined a deficiency of $5,000.

The question presented is whether the interest computation date on the $5,000 deficiency is March 15, 1975, the last date prescribed for payment of any portion of the tax not shown on the Form 7004, or from June 15, 1975, the last date prescribed for payment of the second installment of the unpaid amount of tax shown on the Form 7004, since the total tax liability of $85,000 determined by the Service did not exceed the $90,000 shown as the tax liability on Form 7004.

Section 6152(a) of the Code provides that a corporation subject to taxes imposed by Chapter 1 may elect to pay the unpaid amount of such taxes in two equal installments.

Section 1.6152-1(a)(2) of the regulations provides that a corporation shall be considered to have made an election to pay its taxes in installments if it timely files its return and pays 50 percent of the reported unpaid amount of the tax at such time, or if it files an application on Form 7004 for an automatic extension of time to file the return and pays 50 percent of the amount of the tax at such time.

Section 6601(a) of the Code provides that if any amount of tax is not paid on or before the last date prescribed for payment, interest at an annual rate established under section 6621 on such amount shall be paid for the period from such last date to the date paid.

Rev. Rul. 68-258, 1968-1 C.B. 541, provides that interest runs from the due date of the income tax return only on unpaid tax not shown on the Form 7004. Interest on any unpaid tax shown on the Form 7004, with respect to which the installment privilege has been properly elected, runs only from the installment dates.

Rev. Rul. 68-258, and Rev. Rul. 75-465, 1975-2 C.B. 486, provide that where an unpaid tax liability exists and the taxpayer makes an election to pay such amount in installments, the amount of the second installment has an extended date of June 15, for a calendar year taxpayer, but any other amount has a date of March 15 for computing interest.

In the instant case *X* could not elect the installment privilege under section 6152 of the Code since there was no unpaid tax liability shown on the Form 7004 filed March 14, 1975, for the year 1974.

Accordingly, interest will start to run under section 6601(a) of the Code on the deficiency from March 15, 1975, to the date paid.

Chapter 68.—Additions to the Tax, Additional Amounts, and Assessable Penalties
Subchapter A.—Additions to the Tax and Additional Amounts

Section 6651.—Failure to File Tax Return or to Pay Tax

26 CFR 301.6651-1: Failure to file tax return or to pay tax.
(Also Sections 6020, 301.6020-1.)

Additions to tax; returns prepared by the Service. A return prepared and executed by the Service under section 6020(b) of the Code stops the running of the delinquency period for purposes of additions under section 6651(a)(1) for failure to file; furthermore, additions under section 6651(a)(2) for failure to pay the amount shown on the return are not applicable.

Rev. Rul. 76-562

Advice has been requested (1) whether the delinquency period for the purpose of computing the addition to the tax provided by section 6651(a)(1) of the Internal Revenue Code of 1954 for failure to file a Form 1040, U.S. Individual Income Tax Return, on the date prescribed for filing, stops running when the Internal Revenue Service prepares and executes that return under authority of section 6020(b); and (2) whether the addition to the tax provided by section 6651(a)(2) for failure to pay the amount shown as tax on a Form 1040 is applicable when the Service prepares and executes that return under authority of section 6020(b).

During an audit of the taxpayer's 1972 Form 1040, it was determined that the taxpayer failed to file a Form 1040 for the calendar year 1973 and failed to pay the income tax due for that year. The taxpayer was asked by the Service to submit the required return but refused to do so. Information was obtained from available sources and the Service prepared and executed the required Form 1040 on July 1, 1974.

Section 6012 of the Code requires the filing of individual income tax returns.

Section 6020(b)(1) of the Code authorizes the Secretary or the Secretary's delegate to make any return from personal knowledge and from such information as can be obtained, if any person fails to make any required return at the time prescribed. Section 6020(b)(2) provides that any return made and subscribed by the Secretary or the Secretary's delegate shall be prima facie good and sufficient for all legal purposes.

Section 6651(a)(1) of the Code provides, in general, for an addition to the tax in case of failure to file a return (including one required under section 6012) on or before the prescribed due date, unless the failure is due to reasonable cause and not due to willful neglect. The addition to the tax is at the rate of five percent of the amount required to be shown as tax on the return if the failure is for not more than one month, with an additional five percent for each additional month or fraction thereof

during which the failure continues, not exceeding 25 percent in the aggregate.

Section 6651(a)(2) of the Code provides for an addition to the tax in case of failure to pay the amount shown as tax on any return specified in section 6651(a)(1) on or before the date prescribed for payment of that tax, unless the failure is due to reasonable cause and not due to willful neglect. The addition to the tax is at the rate of one-half percent of the amount of the tax shown on the return if the failure is for not more than one month, with an additional one-half percent for each additional month or fraction thereof during which the failure continues, not exceeding 25 percent in the aggregate.

Rev. Rul. 69-397, 1969-2 C.B. 263, provides that a return filed by the Secretary or the Secretary's delegate under section 6020(b) of the Code is treated as the return filed by the taxpayer. Therefore, that revenue ruling holds that a Form 941, Employer's Quarterly Federal Tax Return, prepared and executed by a District Director of Internal Revenue stops the running of the period of delinquency for purposes of section 6651(a)(1). In Rev. Rul. 70-632, 1970-2 C.B. 286, a Federal income tax return prepared and executed by a District Director under section 6020(b) is treated as the separate return of the taxpayer for the purpose of the election to file a joint return after a separate return was filed.

Accordingly, the income tax return prepared and executed by the Service stops the running of the period of delinquency for the purpose of computing the addition to the tax imposed by section 6651(a)(1) of the Code for failure to file. Since, in this case, the Form 1040 was prepared and executed on July 1, 1974, two and one-half months after the due date, the addition to the tax under section 6651(a)(1) is 15 percent of the amount required to be shown as tax on the return.

The legislative history of section 6651(a)(2) of the Code indicates that Congress intended that section to apply only to taxpayers who filed a return, thereby acknowledging that the amount shown on the return was due as tax, without paying the tax shown on that return. See *S. Rep. No. 91-552*, 91st Cong., 1st Sess. 297-98 (1969), 1969-3 C.B. 423, 611-12. When the Service prepares and executes a return under section 6020(b), there is no acknowledgment by the taxpayer that the amount of tax shown on the return is due.

Accordingly, the addition to the tax provided by section 6651(a)(2) of the Code for failure to pay the amount shown as tax on the return is not applicable to the income tax return prepared and executed by the Service in this case.

These holdings are equally applicable to returns prepared and executed by the Service for other kinds of Federal tax, including estate, gift, excise and employment taxes. Accordingly, the addition to the tax provided by section 6651(a)(2) of the Code is not applicable to any Federal tax return prepared and executed by the Service under authority of section 6020(b), and any such return will stop the running of the period of delinquency for the purpose of computing the addition to the tax imposed by section 6651(a)(1) for failure to file.

Section 6654.—Failure by Individuals to Pay Estimated Income Tax

26 CFR 1.6654-1: Addition to the tax in the case of an individual.
(Also Section 6015; 1.6015(b)-1.)

T.D. 7427[1]

TITLE 26. — INTERNAL REVENUE. — CHAPTER I, SUBCHAPTER A, PART 1. — INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953. — SUBCHAPTER F, PART 301. — PROCEDURE AND ADMINISTRATION

Inclusion of self-employment tax in estimated tax and increase of applicable percentage from 70 percent to 80 percent.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER
OF INTERNAL REVENUE,
Washington, D.C. 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble

By a notice of proposed rule making appearing in the Federal Register for January 6, 1975 (40 F.R. 1044), amendments to the Income Tax Regulations (26 CFR Part 1) and the Regulations on Procedure and Administration (26 CFR Part 301) were proposed in order to conform such regulations to the provisions of sections 102 and 103 of the Tax Adjustment Act of 1966 (80 Stat. 62, 64) [Pub. L. 89-368, 1966-1 C.B. 379] (relating to the inclusion of the self-employment tax in the estimated tax and relating to the increase of the percentage which estimated tax must be of actual tax in order for an individual to avoid having an underpayment of estimated tax), and to minor amendments made by sections 102(a) and 104(a) of the Revenue and Expenditure Control Act of 1968 (82 Stat. 251, 264) [Pub. L. 90-364, 1968-2 C.B. 715]; section 301(b)(12) and (13) of the Tax Reform Act of 1969 (83 Stat. 586) [Pub. L. 91-172, 1969-3 C.B. 10]; section 203(b)(7) of the Act of March 17, 1971 (Pub. Law 92-5, 85 Stat. 11) [1971-1 C.B. 553]; section 203(b)(7) of the Act of July 1, 1972 (Pub. Law 92-336, 86 Stat. 420) [1972-2 C.B. 672] section 203(b)(7) and (d) of the Act of July 9, 1973 (Pub. Law 93-66, 87 Stat. 153) [1973-2 C.B. 439]; and sec-

[1] This publication of the Treasury Decision contains the full text of the regulations. The individual instructions for modifying the notice of proposed rulemaking have been omitted.

tion 5(b)(7), (d), and (f) of the Act of December 31, 1973 (Pub. Law 93-233, 87 Stat. 954) [1974-1 C.B. 380]. All such relevant matters as presented by interested persons regarding the rules proposed having been considered, the proposed amendments of the regulations are adopted by this document without change except for two minor clerical matters.

Adoption of amendments to the regulations

On January 6, 1975, a notice of proposed rule making was published in the Federal Register (40 F.R. 1044) with respect to the Income Tax Regulations (26 CFR Part 1) under sections 170, 1403, 6015, 6017, and 6654 of the Internal Revenue Code of 1954, and the Regulations on Procedure and Administration (26 CFR Part 301) under sections 6015, 6211, and 6654 of the Code to conform such regulations to the provisions of sections 102 and 103 of the Tax Adjustment Act of 1966 (80 Stat. 62, 64) and to minor amendments made by sections 102(a) and 104(a) of the Revenue and Expenditure Control Act of 1968 (82 Stat. 251, 264); section 301(b)(12) and (13) of the Tax Reform Act of 1969 (83 Stat. 586); section 203(b)(7) of the Act of March 17, 1971 (Pub. Law 92-5, 85 Stat. 11); section 203(b)(7) of the Act of July 1, 1972 (Pub. Law 92-336, 86 Stat. 420); section 203(b)(7) and (d) of the Act of July 9, 1973 Pub. Law 93-66, 87 Stat. 153); section 5(b)(7), (d), and (f) of the Act of December 31, 1973 (Pub. Law 93-233, 87 Stat. 954). After consideration of all relevant matter presented by interested persons regarding the proposed rules, the amendment is hereby adopted as proposed, subject to the changes to reflect the prior amendment of § 1.6654 by Treasury Decision 7384 [1975-2 C.B. 489] (40 F.R. 49321), and to make current the statutory provisions and historical note set forth in § 301.6654.

INCOME TAX REGULATIONS (26 CFR Part 1)

Paragraph 1. Paragraph (c) of § 1.170-2 is amended by revising subparagraphs (1)(i) and (2)(iv). These amended provisions read as follows:

§ 1.170-2 Charitable deductions by individuals; limitations (before amendment by Tax Reform Act of 1969).

* * * * *

(c) *Unlimited deduction for individuals*—(1) *In general.* (i) The deduction for charitable contributions made by an individual is not subject to the 10- and 20-percent limitations of section 170(b) if in the taxable year and each of 8 of the 10 preceding taxable years the sum of his charitable contributions paid during the year, plus his payments during the year on account of Federal income taxes, is more than 90 percent of his taxable income for the year (or net income, in years governed by the Internal Revenue Code of 1939). In determining the applicability of the 10- and 20-percent limitations of section 170(b) for taxable years beginning after December 31, 1957, there may be substituted, in lieu of the amount of income tax paid during any year, the amount of income tax paid in respect of such year, provided that any amount so included for the year in respect of which payment was made shall not be included for any other year. For the purpose of the first sentence of this paragraph, taxable income under the 1954 Code is determined without regard to the deductions for charitable contributions under section 170, for personal exemptions under section 151, or for a net operating loss carryback under section 172. On the other hand, for this purpose net income under the 1939 Code is computed without the benefit only of the deduction for charitable contributions. See section 120 of the Internal Revenue Code of 1939. The term 'income tax" as used in section 170(b)(1)(C) means only Federal income taxes, and does not include the taxes imposed on self-employment income, on employees under the Federal Insurance Contributions Act, and on railroad employees and their representatives under the Railroad Retirement Tax Act by chapters 2, 21, and 22, respectively, or corresponding provisions of the Internal Revenue Code of 1939. For purposes of section 170(b)(1)(C) and this paragraph, the amount of income tax paid during a taxable year shall be determined (except as provided in subdivision (ii) of this subparagraph) by including all payments made by the taxpayer during such taxable year on account of his Federal income taxes (whether for the taxable year or for preceding taxable years). Such payments would include any amount paid during the taxable year as estimated tax (exclusive of any portion of such amount for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by chapter 2) for that year, payment of the final installment of estimated tax (exclusive of any portion of such installment, for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by chapter 2) for the preceding taxable year, final payment for the preceding taxable year, and any payment of a deficiency for an earlier taxable year, to the extent that such payments do not exceed the tax for the taxable year for which payment is made. Any payment of income tax with respect to which the taxpayer receives a refund or credit shall be reduced by the amount of such refund or credit. Any such refund or credit shall be applied against the most recent payments for the taxable year in respect of which the refund or credit arose.

* * * * *

(2) *Joint returns.* * * *

(iv) *Allocation.* Whenever it is necessary to allocate the joint tax

liability or the combined taxable income, or both, for a taxable year for which a joint return was filed, a computation shall be made for the taxpayer and for his spouse or former spouse showing for each of them the Federal income taxes and taxable income which would be determined if separate returns had been filed by them for such taxable year. The joint tax liability and combined taxable income for such taxable year shall then be allocated proportionately to the income taxes and taxable income, respectively, so computed. Whenever it is necessary to determine the separate payments made by a taxpayer in respect of a joint tax liability, the amount paid by him during the taxable year as estimated tax (exclusive of any portion of such amount for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by chapter 2) for that year shall be included to the extent it does not exceed his allocable portion of the joint tax under chapter 1 (exclusive of tax under section 56) for the taxable year, and any amount paid by him for a prior year (whether as the final installment of estimated tax—exclusive of any portion of such installment, for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by chapter 2—for the preceding taxable year, or a final payment for the preceding year, or the payment of a deficiency for an earlier year) shall be included to the extent such amount, when added to amounts previously paid by him for such prior year, does not exceed his allocable portion of the joint tax liability for the prior year.

* * * * *

Par. 2. Section 1.1403 is amended by adding a paragraph (3) to section 1.1403(b) and by revising the historical note. These added and amended provisions read as follows:

§ 1.1403 Statutory provisions; miscellaneous provisions.

Sec. 1403. *Miscellaneous provisions.* * * *

(b) *Cross references.* * * *

(3) For provisions relating to declarations of estimated tax on self-employment income, see section 6015.

[Sec. 1403 as amended by sec. 103(m), Social Security Amendments 1960 (74 Stat. 938) [Pub. L. 86-778, 1960-2 C.B. 693]; sec. 102(b)(6), Tax Adjustment Act 1966 (80 Stat. 64) [Pub. L. 89-368, 1966-1 C.B. 379]]

Par. 3. Section 1.1403-1 is amended to read as follows:

§ 1.1403-1 Cross references.

For provisions relating to the requirement for filing returns with respect to net earnings from self-employment, see § 1.6017-1. For provisions relating to declarations of estimated tax on self-employment income, see §§ 1.6015(a) to 1.6015(j)-1, inclusive. For other administrative provisions relating to the tax on self-employment income, see the applicable sections of the regulations in this part (§ 1.6001-1 et seq.) and the applicable sections of the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

Par. 4. Section 1.6015(b)-1 is amended by revising paragraphs (a), (b) and (c). These amended provisions read as follows:

§ 1.6015(b)-1 Joint declaration by husband and wife.

(a) *In general.* A husband and wife may make a joint declaration of estimated tax even though they are not living together. However, a joint declaration may not be made if they are separated under a decree of divorce or of separate maintenance. A joint declaration may not be made if the taxpayer's spouse is a nonresident alien (including a nonresident alien who is a bona fide resident of Puerto Rico during the entire taxable year) or if his spouse has a different taxable year. If the gross income of each spouse meets the requirements of section 6015(a), either a joint declaration must be made or a separate declaration must be made by each. If a joint declaration is made, the amount estimated as the income tax imposed by chapter 1 (other than by section 56) must be computed on the aggregate estimated taxable income of the spouses (see section 6013(d)(3) and § 1.2-1), while (for taxable years beginning after December 31, 1966) the amount estimated as the self-employment tax imposed by chapter 2 must be computed on the separate estimated self-employment income of each spouse. See sections 1401 and 1402 and § 1.6017-1(b)(1). The liability with respect to the estimated tax, in the case of a joint declaration, shall be joint and several.

(b) *Application to separate returns.* The fact that a joint declaration of estimated tax is made by them will not preclude a husband and his wife from filing separate returns. In case a joint declaration is made but a joint return is not made for the same taxable year, the payments made on account of the estimated tax for such year may be treated as payments on account of the tax liability of either the husband or wife for the taxable year or may be divided between them in such manner as they may agree. In the event the husband and wife fail to agree to a division, such payments shall be allocated between them in accordance with the following rule. The portion of such payments to be allocated to a spouse shall be that portion of the aggregate of all such payments as the amount of tax imposed by chapter 1 (other than by section 56) shown on the separate return of the taxpayer (plus, for taxable years beginning after December 31, 1966, the amount of tax imposed by chapter 2 shown on the return of the taxpayer) bears to the sum of the taxes imposed by chapter 1 (other than by section 56) shown on the separate returns of the taxpayer and his spouse (plus, for taxable years beginning after December 31, 1966, the sum of the taxes imposed by chapter

2 shown on the returns of the taxpayer and his spouse). For example, assume that for calendar year 1972 H and his spouse W make a joint declaration of estimated tax and, pursuant thereto, pay a total of $19,500 of estimated tax. H and W subsequently file separate returns for 1972 showing tax imposed by chapter 1 (other than by section 56) in the amount of $11,500 and $8,000, respectively. In addition, H's return shows a tax imposed by chapter 2 in the amount of $500. H and W fail to agree to a division of the estimated tax paid. The amount of the aggregate estimated tax payments allocated to H is computed as follows:

(1) Amount of tax imposed by chapter 1 (other than by section 56) shown on H's return	$11,500
(2) Plus: Amount of tax imposed by chapter 2 shown on H's return	500
(3) Total taxes imposed by chapter 1 (other than by section 56) and by chapter 2 shown on H's return	$12,000
(4) Amount of tax imposed by chapter 1 (other than by section 56) shown on W's return	8,000
(5) Total taxes imposed by chapter 1 (other than by section 56) and by chapter 2 shown on both H's and W's returns	$20,000
(6) Proportion of such taxes shown on H's return to total amount of such taxes shown on both H's and W's returns ($12,000 ÷ 20,000)	60%
(7) Amount of estimated tax payments allocated to H (60% of $19,500)	$11,700

Accordingly, Hs return would show remaining tax liability in the amount of $300 ($12,000 taxes shown less $11,700 estimated tax allocated).

(c) *Death of spouse.* (1) A joint declaration may not be made after the death of either the husband or wife. However, if it is reasonable for a surviving spouse to assume that there will be filed a joint return for himself and the deceased spouse for his taxable year and the last taxable year of the deceased spouse he may, in making a separate declaration for his taxable year which includes the period comprising such last taxable year of his spouse, estimate the amount of the tax imposed by chapter 1 (other than by section 56) on his and his spouse's taxable income on an aggregate basis and compute his estimated tax with respect to such chapter 1 tax in the same manner as though a joint declaration had been filed.

(2) If a joint declaration is made by husband and wife and thereafter one spouse dies, no further payments of estimated tax on account of such joint declaration are required from the estate of the decedent. The surviving spouse, however, shall be liable for the payment of any subsequent installments of the joint estimated tax unless an amended declaration setting forth the separate estimated tax for the taxable year is made by such spouse. Such separate estimated tax shall be paid at the times and in the amounts determined under the rules prescribed in section 6153. For purposes of (i) the making of such an amended declaration by the surviving spouse, and (ii) the allocation of payments made pursuant to a joint declaration between the surviving spouse and the legal representative of the decedent in the event a joint return is not filed, the payments made pursuant to the joint declaration may be divided between the decedent and the surviving spouse in such proportion as the surviving spouse and the legal representative of the decedent may agree. In the event the surviving spouse and the legal representative of the decedent fail to agree to a division, such payments shall be allocated in accordance with the following rule. The portion of such payments to be allocated to the surviving spouse shall be that portion of the aggregate amount of such payments as the amount of tax imposed by chapter 1 (other than by section 56) shown on the separate return of the surviving spouse (plus, for taxable years beginning after December 31, 1966, the amount of tax imposed by chapter 2 shown on the return of the surviving spouse) bears to the sum of the taxes imposed by chapter 1 (other than by section 56) shown on the separate returns of the surviving spouse and on the decedent (plus, for taxable years beginning after December 31, 1966, the sum of the taxes imposed by chapter 2 shown on the returns of the surviving spouse and of the decedent); and the balance of such payments shall be allocated to the decedent. This rule may be illustrated by analogizing the surviving spouse described in this rule to H in the example contained in paragraph (b) of this section and the decedent in this rule to W in that example.

* * * * *

Par. 5. Section 1.6015(c) is amended to read as follows:

§ 1.6015(c) Statutory provisions; declaration of estimated income tax by individuals; estimated tax.

Sec. 6015. *Declaration of estimated income tax by individuals.* * * *

(c) *Estimated tax.* For purposes of this title, in the case of an individual, the term "estimated tax" means—

(1) The amount which the individual estimates as the amount of the income tax imposed by chapter 1 for the taxable year (other than the tax imposed by section 56), plus

(2) The amount which the individual estimates as the amount of the self-employment tax imposed by chapter 2 for the taxable year, minus

(3) The amount which the individual estimates as the sum of any credits against tax provided by part IV of subchapter A of chapter 1.

[Sec. 6015(c) as amended by sec. 102(a), Tax Adjustment Act 1966 (80 Stat. 62 [Pub. L. 89-368, 1966-1 C.B. 379]; sec. 301(b)(12), Tax Reform Act 1969 (83 Stat. 586) [Pub. L. 91-172, 1969-3 C.B. 10]]

Par. 6. Section 1.6015(c)-1 is amended to read as follows:

§ 1.6015(c)-1 Definition of estimated tax.

In the case of an individual, the term "estimated tax" means—

(a) The amount which the individual estimates as the amount of the income tax imposed by chapter 1 (other than the tax imposed by section 56 or, for taxable years ending before September 30, 1968, the tax surcharge imposed by section 51) for the taxable year, plus

(b) For taxable years beginning after December 31, 1966, the amount which the individual estimates as the amount of the self-employment tax imposed by chapter 2 for the taxable year, minus

(c) The amount which the individual estimates as the sum of any credits against tax provided by part IV of subchapter A of chapter 1. These credits are those provided by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds), section 33 (relating to the credit for dividends received on or before December 31, 1964), section 35 (relating to partially tax-exempt interest), section 37 (relating to retirement income), section 38 (relating to the investment credit), section 39 (relating to certain uses of gasoline, special fuels, and lubricating oils), section 40 (relating to expenses of work incentive programs), section 41 (relating to contributions to candidates), and section 42 (relating to overpayments of tax). An individual who expects to elect to pay the optional tax imposed by section 3, or one who expects to elect to take the standard deduction allowed by section 144, should disregard any credits otherwise allowable under sections 32, 33, and 35 in computing his estimated tax since, if he so elects, these credits are not allowed in computing his tax liability. See section 36. For example, if a self-employed individual estimates that his liabilities for income tax and self-employment tax for 1973 will be $1,600 and $400, respectively, he is required to declare and pay an estimated tax of $2,000 for that year.

Par. 7. Paragraph (b) of § 1.6015(d)-1 is amended to read as follows:

§ 1.6015 (d)-1 Contents of declaration of estimated tax.

* * * * *

(b) *Computation of estimated tax.* In computing the estimated tax the taxpayer should take into account the following:

(1) The amount estimated as the income tax imposed by chapter 1 (other than by section 56) for the taxable year after the application of any allowable amounts estimated as the credit for foreign taxes, the dividends received credit (for dividends received on or before December 31, 1964), the credit for partially tax-exempt interest, the retirement income credit, the investment credit, the credit for expenses of work incentive programs, the credit for contributions to candidates, the credit for overpayments of tax, but without regard to the credit under section 31 for tax withheld on wages or to the credit under section 39 for certain uses of gasoline, special fuels, and lubricating oils;

(2) For taxable years beginning after December 31, 1966 (and, if the taxpayer so desires, for an earlier taxable year), the amount estimated as the tax on self-employment income imposed by chapter 2;

(3) The amounts estimated by the taxpayer as the credits under section 31 for tax withheld on wages and under section 39 for certain uses of gasoline, special fuels, and lubricating oils; and

(4) The excess, if any, of the sum of the amounts shown under subparagraphs (1) and (2) of this paragraph over the amount shown under subparagraph (3) of this paragraph, which excess shall be the estimated tax for such taxable year.

* * * * *

Par. 8. Section 1.6015(e)-1 is amended to read as follows:

§ 1.6015(e)-1 Amendment of declaration.

In the making of a declaration of estimated tax, the taxpayer is required to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, allowable deductions, and estimated credits for the taxable year. Amended or revised declarations may be made in any case in which the taxpayer estimates that his gross income, deductions, or credits will differ from the gross income, deductions, or credits reflected in the previous declaration. An amended declaration may also be made based upon a change in the number of exemptions to which the taxpayer may be entitled for the then current taxable year. However, only one amended declaration may be filed during any interval between installment dates. See paragraph (d) of § 1.6073-1. An amended declaration may be filed jointly by husband and wife even though separate declarations have previously been filed. An amended declaration must be made on Form 1040-ES (marked "Amended"). See, however, paragraph (c) of § 1.6015(d)-1 for procedure to be followed if the prescribed form is not available.

Par. 9. Paragraph (b) of § 1.6015(g)-1 is amended to read as follows:

§ 1.6015(g)-1 Short taxable years of individuals.

* * * * *

(b) *Income and income tax placed on annual basis.* For the purpose of determining whether the anticipated income and tax for a short taxable year resulting from a change of annual accounting period necessitates the filing of a declaration, income and in-

come tax imposed by chapter 1 (other than by section 56) shall be placed on an annual basis in the manner prescribed in section 443(b)(1). Thus, for example, an unmarried taxpayer who changes from a fiscal year basis to a calendar year basis beginning January 1, 1973, will have a short taxable year begininng July 1, 1972, and ending December 31, 1972. If his anticipated gross income for such short taxable year consists solely of wages (as defined in section 3401(a)) in the amount of $11,000, his total gross income and his gross income from such wages for the purpose of determining whether a declaration is required is $22,000, the amount obtained by placing anticipated income of $11,000 upon an annual basis. Since the taxpayer's anticipated gross income from wages when placed upon an annual basis is in excess of $20,000, he is required to file a declaration of estimated tax for the short taxable year unless the estimated tax can reasonably be expected to be less than $100. However, for taxable years beginning after December 31, 1966, the amount which the individual estimates as the amount of self-employment tax imposed by chapter 2 shall be computed on the actual self-employment income for the short period.

* * * * *

Par. 10. Section 1.6017-1 is amended by adding a paragraph (d) which reads as follows:

§ 1.6017-1 Self-employment tax returns

* * * * *

(d) *Declaration of estimated tax with respect to taxable years beginning after December 31, 1966.* For taxable years beginning after December 31, 1966, section 6015 provides that the term "estimated tax" includes the amount which an individual estimates as the amount of self-employment tax imposed by chapter 2 for the taxable year. Thus, individuals upon whom self-employment tax is imposed by section 1401 must make a declaration of estimated tax if they meet the requirements of section 6015(a), except as otherwise provided under section 6015(i).

Par. 11. Section 1.6654 is amended by revising subsections (b), (d) and (f) of section 6654. The amended provisions read as follows:

§ 1.6654 Statutory provisions; failure by individual to pay estimated income tax.

Sec. 6654. *Failure by individual to pay estimated income tax*—***

* * * * *

(b) *Amount of underpayment.* For purposes of subsection (a), the amount of the underpayment shall be the excess of—

(1) The amount of the installment which would be required to be paid if the estimated tax were equal to 80 percent (66⅔ percent in the case of individuals referred to in section 6073(b), relating to income from farming or fishing) of the tax shown on the return for the taxable year or, if no return was filed, 80 percent (66⅔ percent in the case of individuals referred to in section 6073(b), relating to income from farming or fishing) of the tax for such year, over

(2) The amount, if any, of the installment paid on or before the last date prescribed for such payment.

* * * * *

(d) *Exception.* Notwithstanding the provisions of the preceding subsections, the addition to the tax with respect to any underpayment of any installment shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceeds the amount which would have been required to be paid on or before such date if the estimated tax were whichever of the following is the least—

(1) The tax shown on the return of the individual for the preceding taxable year, if a return showing a liability for tax was filed by the individual for the preceding taxable year and such preceding year was a taxable year of 12 months.

(2) An amount equal to 80 (percent (66⅔ percent in the case of individuals referred to in section 6073(b), relating to income from farming or fishing) of the tax for the taxable year computed by placing on an annualized basis the taxable income for the months in the taxable year ending before the month in which the installment is required to be paid and by taking into account the adjusted self-employment income (if the net earnings from self-employment (as defined in section 1402(a)) for the taxable year equal or exceed $400). For purposes of this paragraph—

(A) The taxable income shall be placed on an annualized basis by—

(i) Multiplying by 12 (or, in the case of a taxable year of less than 12 months, the number of months in the taxable year) the taxable income (computed without deduction of personal exemptions) for the months in the taxable year ending before the month in which the installment is required to be paid,

(ii) Dividing the resulting amount by the number of months in the taxable year ending before the month in which such installment date falls, and

(iii) Deducting from such amount the deductions for personal exemptions allowable for the taxable year (such personal exemptions being determined as of the last date prescribed for payment of the installment).

(B) The term "adjusted self-employment income" means—

(i) The net earnings from self-employment (as defined in section 1402(a)) for the months in the taxable year ending before the month in which the installment is required to be paid, but not more than

(ii) The excess of (I) an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which the taxable year begins, over (II) the amount determined by placing the wages (within the meaning of section 1402(b)) for the months in the taxable year ending before the month in which the installment is required to be paid on an annualized basis in a manner consistent with clauses (i) and (ii) of subparagraph (A).

(3) An amount equal to 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income and the actual self-employment income for the months in the taxable year ending before the month in which the installment is required to be paid as if such months constituted the taxable year.

(4) An amount equal to the tax computed, at the rates applicable to the taxable year, on the basis of the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on his return for, and the law applicable to, the preceding taxable year.

* * * * *

(f) *Tax computed after application of credits against tax.* For purposes of subsections (b) and (d), the term "tax" means—

(1) The tax imposed by this chapter 1 (other than by section 56), plus

(2) The tax imposed by chapter 2, minus

(3) The credits against tax allowed by part IV of subchapter A of chapter 1, other than the credit against tax provided by section 31 (relating to tax withheld on wages).

* * * * *

Par. 12. Section 1.6654-1 is amended by revising paragraphs (a)(1) and (4) and by revising example (1) of paragraph (c), to read as follows:

§ 1.6654-1 Addition to the tax in the case of an individual.

(a) *In general.* (1) Section 6654 imposes an addition to the taxes under chapters 1 and 2 of the Code in the case of any underpayment of estimated tax by an individual (with certain exceptions described in section 6654 (d)). This addition to the tax is in addition to any applicable criminal penalties and is imposed whether or not there was reasonable cause for the underpayment. The amount of the underpayment for any installment date is the excess of—

(i) The following percentages of the tax shown on the return for the taxable year or, if no return was filed, of the tax for such year, divided by the number of installment dates prescribed for such taxable year:

(A) 80 percent in the case of taxable years beginning after December 31, 1966, of individuals not referred to in section 6073(b) (relating to income from farming or fishing);

(B) 70 percent in the case of taxable years beginning before January 1, 1967, of such individuals; and

(C) 66⅔ percent in the case of individuals referred to in section 6073 (b); over

(ii) The amount, if any, of the installment paid on or before the last day prescribed for such payment.

* * * * *

(4) The term "tax" when used in subparagraph (1)(i) of this paragraph shall mean—

(i) The tax imposed by chapter 1 of the Code (other than by section 56 or, for taxable years ending before September 30, 1968, the tax surcharge imposed by section 51), plus

(ii) For taxable years beginning after December 31, 1966, the tax imposed by chapter 2 of the Code, minus

(iii) All credits allowed by part IV, subchapter A of chapter 1, except the credit provided by section 31, relating to tax withheld at source on wages. For the disallowance of certain credits in the case of taxpayers who elect to use the standard deduction or to pay the optional tax imposed by section 3, see section 36.

* * * * *

(c) *Examples.* * * *

Example (1). An individual taxpayer files his return for the calendar year 1972 on April 15, 1973 showing a tax (income and self-employment tax) of $30,000. He had paid a total of $20,000 of estimated tax in four installments of $5,000 on each of the four installment dates prescribed for such year. No other payments were made prior to the date the return was filed. Since the amount of each installment paid by the last date prescribed for payment thereof is less than one-quarter of 80 percent of the tax shown on the return, the addition to the tax is applicable in respect of the underpayment existing as of each installment date and is computed as follows:

(1) Amount of tax shown on return		$30,000
(2) 80 percent of item (1)		24,000
(3) One-fourth of item (2)		$ 6,000
(4) Deduct amount paid on each installment date		$ 5,000
(5) Amount of underpayment for each installment date (item (3) minus item (4))		$ 1,000
(6) Addition to the tax:		
1st installment — period 4-15-72- to 4-15-73	$ 60	
2nd installment — period 6-15-72 to 4-15-73	50	
3rd installment — period 9-15-72 to 4-15-73	35	
4th installment — period 1-15-73 to 4-15-73	15	
Total	$160	

* * * * *

Par. 13. Section 1.6654-2 is amended to read as follows:

§ 1.6654-2 Exceptions to imposition of the addition to the tax in the case of individuals.

(a) *In general.* The addition to the tax under section 6654 will not be imposed for any underpayment of any installment of estimated tax if, on or before the date prescribed for payment of the installment, the total amount of all payments of estimated tax made equals or exceeds the least of the following amounts—

(1) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were the tax shown on the return for the preceding taxable year, provided that the preceding taxable year was a year of 12 months and a return showing a liability for tax was filed for such year. However, this subparagraph shall not apply with respect to any taxable year which ends on or after September 30, 1968, for which a tax is imposed by section 51 (relating to tax surcharge), in the case of a payment of estimated tax the time prescribed for payment of which is on or after September 15, 1968.

(2) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to a percentage of the tax computed by placing on an annual basis the taxable income for the calendar months in the taxable year ending before the month in which the installment is required to be paid. That percentage is 80 percent in the case of taxable years beginning after December 31, 1966, of individuals not referred to in section 6073(b) (relating to income from farming or fishing), 70 percent in the case of taxable years beginning before January 1, 1967, of such individuals, and 66⅔ percent in the case of individuals referred to in section 6073(b). With respect to taxable years beginning after December 31, 1966, the adjusted self-employment income shall be taken into account in determining the amount referred to in this subparagraph if net earnings from self-employment (as defined in section 1402(a)) for the taxable year equal

or exceed $400. For purposes of this subparagraph—

(i) Taxable income shall be placed on an annual basis by—

(A) Multiplying by 12 (or the number of months in the taxable year if less than 12) the taxable income (computed without the standard deduction and without the deduction for personal exemptions), or the adjusted gross income if the standard deduction is to be used, for the calendar months in the taxable year ending before the month in which the installment is required to be paid,

(B) Dividing the resulting amount by the number of such calendar months, and

(C) Deducting from such amount the standard deduction, if applicable, and the deduction for personal exemptions (such personal exemptions being determined as of the date prescribed for payment of the installment).

(ii) The term "adjusted self-employment income" means—

(A) The net earnings from self-employment (as defined in section 1402(a)) for the calendar months in the taxable year ending before the month in which the installment is required to be paid, computed as if such months constituted the taxable year, but not more than

(B) The excess of—

(*1*) For taxable years beginning after 1966, $6,600,

(*2*) For taxable years beginning after 1971, $9,000,

(*3*) For taxable years beginning after 1972, $10,800,

(*4*) For taxable years beginning after 1973, $13,200, and

(*5*) For taxable years beginning after 1974, an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which the taxable year begins,

over the amount of the wages (within the meaning of section 1402(b)) for such calendar months placed on an annual basis. For this purpose, wages are annualized in a manner consistent with subdivision (i)(A) and (B) of this subparagraph, that is, by multiplying by 12 (or the number of months in the taxable year in the case of a taxable year of less than 12 months) the wages for such calendar months and dividing the resulting amount by the number of such months.

(3) An amount equal to 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income for the calendar months in the taxable year ending before the month in which the installment is required to be paid, as if such months constituted the entire taxable year. For taxable years beginning after December 31, 1966, such computation shall include the tax imposed by chapter 2 on the actual self-employment income for such months. For purposes of this subparagraph, the term "actual self-employment income" means—

(i) The net earnings from self-employment (as defined in section 1402(a)) for such calendar months, computed as if such months constituted the taxable year, but not more than

(ii) The excess of—

(A) For taxable years beginning after 1966, $6,600,

(B) For taxable years beginning after 1971, $9,000,

(C) For taxable years beginning after 1972, $10,800,

(D) For taxable years beginning after 1973, $13,200, and

(E) For taxable years begininng after 1974, an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which the taxable year begins,

over the amount of wages (within the meaning of section 1402(b)) for such months.

(4) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to a tax determined on the basis of the tax rates and the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year, in the case of an individual required to file a return for such preceding taxable year.

In the case of a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441(f), the rules prescribed by paragraph (b) of § 1.441-2 shall be applicable in determining, for purposes of subparagraph (1) of this paragraph, whether a taxable year was a year of 12 months and, for purposes of subparagraphs (2) and (3) of this paragraph, the number of calendar months in a taxable year preceding the date prescribed for payment of an installment of estimated tax. For the rules to be appled in determining taxable income for any period described in subparagraphs (2) and (3) of this paragraph in the case of a taxpayer who employs accounting periods (*e.g.*, thirteen 4-week periods or four 13-week periods) none of which terminates with the end of the applicable period described in subparagraph (2) or (3) of this paragraph, see paragraph (a)(5) of § 1.6655-2.

(b) *Meaning of terms.* As used in this section and § 1.6654-3—

(1) The term "tax" means—

(i) The tax imposed by chapter 1 of the Code (other than by section 56), plus

(ii) For taxable years beginning after December 31, 1966, the tax imposed by chapter 2 of the Code, minus

(iii) The credits against tax allowed by part IV, subchapter A, chapter 1 of the Code, other than the credit against tax provided by section 31 (relating to tax withheld

on wages), and without reduction for any payments of estimated tax.

(2) The credits against tax allowed by part IV, subchapter A, chapter 1 of the Code, are—

(i) In the case of the exception described in paragraph (a)(1) of this section, the credits shown on the return for the preceding taxable year,

(ii) In the case of the exceptions described in paragraph (a)(2) and (3) of this section, the credits computed under the law and rates applicable to the current taxable year, and

(iii) In the case of the exception described in paragraph (a)(4) of this section, the credits shown on the return for the preceding taxable year, except that if the amount of any such credit would be affected by any change in rates or status with respect to personal exemptions, the credits shall be determined by reference to the rates and status applicable to the current taxable year.

A change in rate may be either a change in the rate of tax, such as a change in the rate of tax imposed by section 1 or section 1401, or a change in a percentage affecting the computation of a credit, such as a change in the rate of withholding under chapter 3 of the Code or a change in the percentage of a qualified investment which is specified in section 46 for use in determining the amount of the investment credit allowed by section 38.

(3) The term "return for the preceding taxable year" means the income tax return for such year which is required by section 6012(a)(1) and, in the case of taxable years beginning after December 31, 1966, the self-employment tax return for such year which is required by section 6017.

(c) *Examples.* The following examples illustrate the application of the exceptions to the imposition of the addition to the tax for an underpayment of estimated tax, in the case of an individual whose taxable year is the calendar year:

Example (1). A, a married man with one child and a dependent parent, files a joint return with his spouse, B, for 1955 on April 15, 1956, showing taxable income of $44,000 and a tax of $16,760. A and B had filed a joint declaration of estimated tax on April 15, 1955, showing an estimated tax of $10,000 which was paid in four equal installments of $2,500 each on April 15, June 15, and September 15, 1955, and January 15, 1956. The balance of $6,760 was paid with the return. A and B have an underpayment of estimated tax of $433 (¼ of 70% of $16,760 less $2,500) for each installment date. The 1954 calendar year return of A and B showed a liability of $10,000. Since the total amount of estimated tax paid by each installment date equalled the amount that would have been required to be paid on or before each of such dates if the estimated tax were the tax shown on the return for the preceding year, the exception described in paragraph (a)(1) of this section applies and no addition to the tax will be imposed.

Example (2). Assume the same facts as in example (1), except that the joint return of A and B for 1954 showed taxable income of $32,000 and a tax liability of $10,400. Assume further that only two personal exemptions under section 151 appeared on the 1954 return. The exception described in paragraph (a)(1) of this section would not apply. However, A and B are entitled to four exemptions under section 151 for 1955. Taxable income for 1954 based on four exemptions, but otherwise on the basis of the facts shown on the 1954 return, would be $30,800. The tax on such amount in the case of a joint return would be $9,836. Since the total amount of estimated tax paid by each installment date exceeds the amount which would have been required to be paid on or before each of such dates if the estimated tax were $9,836, the exception described in paragraph (a)(4) of this section applies and no addition to the tax will be imposed.

Example (3). C, who is self-employed (other than as a farmer or fisherman), has annualized taxable income of $6,900 for the period January 1, 1967, through August 31, 1967, the income tax on which is $1,171. For the same period his net earnings from self-employment are $5,000 and his wages are $2,000. The estimated tax payments made by C for 1967 on or before September 15, 1967, total $1,200. For the purposes of the exception described in paragraph (a)(2) of this section, the adjusted self-employment income is $3,600, computed as follows:

(1) Net earnings from self-employment	$5,000
(2) $6,600 minus annualized wages ($6,600—3,000 ($2,000 × 12 ÷ 8))	$3,600
(3) Lesser of (1) or (2)	$3,600

The tax on C's adjusted self-employment income would be $230.40 ($3,600 × 6.4 percent.) Since the total amount of estimated tax paid on or before September 15, 1967, exceeds $1,121.12, that is, 80 percent of $1,401.40 ($1,171 + 230.40), the exception described in paragraph (a)(2) of this section applies and no addition to tax will be imposed.

Example (4). D, who is self-employed (other than as a farmer or fisherman), has actual taxable income of $3,800 for the period January 1, 1967, through August 31, 1967, the income tax on which is $586. For the same period his net earnings from self-employment are $5,000 and his wages are $2,000. The estimated tax payments made by D for 1967 on or before September 15, 1967, total $840. For the purposes of the exception described in paragraph (a)(3) of this section, the actual self-employment income for this period is $4,600, computed as follows:

(1) Net earnings from self-employment	$5,000
(2) $6,600 minus wages ($6,600—2,000)	$4,600
(3) Lesser of (1) or (2)	$4,600

The tax on D's actual self-employment income would be $294.40 ($4,600 × 6.4 percent. Since the total amount of estimated tax paid by September 15, 1967, exceeds $792.36, that is, 90 percent of $880.40 ($586 + 294.40), the exception described in paragraph (a)(3) of this section applies and no addition to tax will be imposed.

Example (5). E and F, his spouse, filed a joint return for the calendar year 1967 showing a tax liability of $10,000. The liability, attributable primarily to income received during the last quarter of the year, included both income and self-employment tax. Their aggregate payments of estimated tax on or before September 15, 1967, total $1,350, representing three installments of $450 paid on each of the first three installment dates prescribed for the taxable year. Since each installment paid, $450, was less than $2,000 (¼ of 80 percent of $10,000), there was an underpayment on each of the installment dates. Assume that the exceptions described in paragraph (a)(1) and (4) of this section do not apply. Actual taxable income for the three months ending March 31, was $2,000 and for the five months ending May 31, 1967, was $4,500. Actual self-employment income, for the same periods, was $2,000 and $4,000, respectively. Since the amounts paid by the April 15 and June 15 installment dates, $450 and $900, respectively, exceed $376.20 and $873.90, respectively (90 percent of the income tax on the actual taxable income of $2,000 and $4,500, respectively, determined on the basis of a joint return, and the self-employment tax on the actual self-employment income of $2,000 and $4,000, respectively), the exception described in paragraph (a)(3) of this section applies and no addition to the tax will be imposed for the under-

payments on the April 15 and June 15 installment dates. For the eight months ending August 31, 1967, actual taxable income, assuming E and F did not elect to use the standard deduction, was $7,500; net earnings from self-employment were $6,000; and wages were $2,700. Since the total amount paid by the September 15 installment date, $1,350, was less than $1,381.14 (90 percent of the income tax on the actual taxable income of $7,500 determined on the basis of a joint return and the self-employment tax on actual self-employment income of $3,900 ($6,600 — 2,700)), the exception described in paragraph (a)(3) of this section does not apply to the September 15 installment. Furthermore, the exception described in paragraph (a)(2) of this section does not apply, as illustrated by the following computation:

(1)	Income tax:	
	Taxable income for the period ending August 31, 1967 (without deduction for personal exemptions) on an annual basis ($8,700 × 12 ÷ 8)	$13,050.00
	Deduction for two personal exemptions	1,200.00
		$11,850.00
	Tax on $11,850 (on the basis of a joint return)	$ 2,227.00
(2)	Self-employment tax:	
	Net earnings from self-employment	$ 6,000.00
	Adjusted self-employment income ($6,600 — 4,050 annualized wages (2,700 × 12 ÷ 8)	$ 2,550.00
	Tax on adjusted self-employment income ($2,550 × 6.4 percent)	$ 163.20
(3)	Total tax ($2,227.00 + 163.20)	$ 2,390.20
(4)	¾ of 80 percent of $2,390.20	$ 1,434.12
	Amount paid by Sept. 15, 1967	$ 1,350.00

An addition to the tax will thus be imposed for the underpayment of $1,550 ($2,000 — 450) on the September 15 installment.

Example (6). Assume the same facts as in example (5) and assume further that adjusted gross income for the eight months ending August 31, 1967, was $9,200 and the amount of deductions (other than the deduction for personal exemptions) not allowable in determining adjusted gross income aggregated only $500. If E and F elect, they may use the standard deduction in computing the tax for purposes of the exceptions described in paragraph (a)(2) and (3) of this section. Taxable income for purposes of the exception described in paragraph (a)(3) of this section would be reduced to $7,080 ($9,200 less $1,200 for two personal exemptions and $920 for the standard deduction). The income tax thereon is $1,205.20; income tax and self-employment tax total $1,454.80 ($1,205.20 + 249.60 ($3,900 × 6.4 percent)). Since the amount paid by the September 15 installment date, $1,350, exceeds $1,309.32 (90 percent of $1,454.80), the exception described in paragraph (a)(3) of this section applies. However, the exception described in paragraph (a)(2) of this section does not apply, as illustrated by the following computation:

Adjusted gross income for the period ending August 31, 1967	$ 9,200.00
Adjusted gross income annualized ($9,200 × 12 ÷ 8)	$13,800.00
Taxable income annualized ($13,800 minus $1,200 for two personal exemptions and $1,000 for the standard deduction)	$11,600.00
Income tax on $11,600 (on basis of a joint return)	$ 2,172.00
Self-employment tax on adjusted self-employment income $2,550 × 6.4 percent)	$ 163.20
Total tax ($2,172.00+163.20)	$ 2,335.20
¾ of 80 percent of $2,335.20	$ 1,401.12
Amount paid by Sept. 15, 1967	$ 1,350.00

Example (7). G was a married individual, 73 years of age, who filed a joint return with his wife, H, for the calendar year 1956. H, who was 70 years of age, had no income during the year. G had taxable income in the amount of $7,000 for the eight-month period ending on August 31, 1956, which included $2,000 of dividend income (after excluding $50 under section 116) and $900 of rental income. The $7,000 figure also reflected a deduction of $2,400 for personal exemptions ($600 × 4), since G and H are both over 65 years of age. The application of the exception described in paragraph (a)(2) of this section to an underpayment of estimated tax on the September 15th installment date may be illustrated by the following computation:

Taxable income for the period ending August 31, 1956 (without deduction for personal exemptions) on an annual basis ($9,400 × 12 ÷ 8)		$14,100.00
Deduction for personal exemptions		2,400.00
Taxable income on an annual basis		$11,700.00
Tax (on the basis of a joint return)		$ 2,642.00
Dividends received for 8-month period	$2,050	
Less: Amount excluded from gross income under section 116	50	
Dividends included in gross income	$2,000	
Dividend income annualized ($2,000 × 12 ÷ 8)	$3,000	
Dividends received credit under section 34 (4 percent of $3,000)		120.00
Tax less dividends received credit		$ 2,522.00
Retirement income (as defined in section 37(c)) includes:		
Dividend income (to extent included in gross income)	$2,000	
Rental income	900	
Total retirement income	$2,900	
Limit on amount of retirement income under section 37(d)	$1,200	
Retirement income credit under section 37 (20 percent of $1,200)		240.00
Tax less credits under section 34 and section 37		$ 2,282.00
Amount determined under the exception described in paragraph (a)(2) of this section (¾ of 70 percent of $2,282)		$ 1,198.05

(d) *Determination of taxable income for installment periods*—(1) *In general.* (i) In determining the applicability of the exceptions described in paragraph (a)(2) and (3) of this section, these must be an accurate determination of the amount of income and deductions for the calendar months in the taxable year preceding the installment date as of which the determination is made, that is, for the period terminating with the last day of the third, fifth, or eighth month of the taxable year. For example, a taxpayer distributes year-end bonuses to his employees but does not determine the amount of the bonuses until the last month of the taxable year. He may not deduct any portion of such year-end bonuses in determining his taxable income for any installment period other than the final installment period for the taxable year, since deductions are not allowable until paid or accrued, depending on the taxpayer's method of accounting.

(ii) If a taxpayer on an accrual method of accounting wishes to use either of the exceptions described in paragraph (a)(2) and (3) of this section, he must establish the amount of income and deductions for each applicable period. If his income is derived from a business in which the production, purchase, or sale of merchandise is an income-producing factor requiring the use of inventories, he will be unable to determine accurately the amount of his taxable in-

come for the applicable period unless he can establish, with reasonable accuracy, his cost of goods sold for the applicable installment period. The cost of goods sold for such period shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such installment period is of gross receipts from sales for the entire taxable year.

(2) *Members of partnerships.* The provisions of this subparagraph shall apply in determining the applicability of the exceptions described in paragraph (a)(2) and (3) of this section to an underpayment of estimated tax by a taxpayer who is a member of a partnership.

(i) For purposes of determining taxable income, there shall be taken into account—

(A) The partner's distributive share of partnership items set forth under section 702,

(B) The amount of any guaranteed payments under section 707(c), and

(C) Gains or losses on partnership distributions which are treated as gains or losses on sales of property.

(ii) For purposes of determining net earnings from self-employment (for taxable years beginning after December 31, 1966) there shall be taken into account—

(A) The partner's distributive share of income or loss, described in section 702(a)(9), subject to the special rules set forth in section 1402 (a) and §§ 1.1402(a)-1 to 1.1402(a)-16, inclusive, and

(B) The amount of any guaranteed payments under section 707(c), except for payments received from a partnership not engaged in a trade or business within the meaning of section 1402(c) and § 1.1402(c)-1.

In determining a partner's taxable income and, for taxable years beginning after December 31, 1966, net earnings from self-employment, for the months in his taxable year which precede the month in which the installment date falls, the partner shall take into account items set forth in sections 702 and 1402(a) for any partnership taxable year ending with or within his taxable year to the extent that such items are attributable to months in such partnership taxable year which precede the month in which the installment date falls. For special rules used in computing a partner's net earnings from self-employment in the case of the termination of his taxable year as a result of death, see section 1402(f) and § 1.1402(f)-1. In addition, a partner shall include in his taxable income and, for taxable years beginning after December 31, 1966, net earning from self-employment, for the months in his taxable year which precede the month in which the installment date falls guaranteed payments from the partnership to the extent that such guaranteed payments are includible in his taxable income for such months. See section 706(a), section 707(c), paragraph (c) of § 1.707-1 and section 1402(a).

(iii) The provisions of subdivision (i)(A) and (B) and subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example (1). A, whose taxable year is the calendar year, is a member of a partnership whose taxable year ends on January 31st. A must take into account, in determining his taxable income for the installment due on April 15, 1973, all of his distributive share of partnership items described in section 702 and the amount of any guaranteed payments made to him which were deductible by the partnership in the partnership taxable year beginning on February 1, 1972, and ending on January 31, 1973. A must take into account, in determining his net earnings from self-employment, his distributive share of partnership income or loss described in section 702(a)(9), subject to the special rules set forth in section 1402(a) and §§ 1.1402(a)-1 to 1.1402(a)-16, inclusive.

Example (2). Assume that the taxable year of the partnership of which A, a calendar year taxpayer, is a member ends on June 30th. A must take into account in the determination of his taxable income and net earnings from self-employment for the installment due on April 15, 1973, his distributive share of partnership items for the period July 1, 1972, through March 31, 1973; for the installment due on June 15, 1973, he must take into account such amounts for the period July 1, 1972, through May 31, 1973; and for the installment due on September 15, 1973, he must take into account such amounts for the entire partnership taxable year of July 1, 1972, through June 30, 1973 (the date on which the partnership taxable year ends).

(3) *Beneficiaries of estates and trusts.* In determining the applicability of the exceptions described in paragraph (a)(2) and (3) of this section as of any installment date, the beneficiary of an estate or trust must take into account his distributable share of income from the estate or trust for the applicable period (whether or not actually distributed) if the trust or estate is required to distribute income to him currently. If the estate or trust is not required to distribute income currently, only the amounts actually distributed to the beneficiary during such period must be taken into account. If the taxable year of the beneficiary and the taxable year of the estate or trust are different, there shall be taken into account the beneficiary's distributable share of income, or the amount actually distributed to him as the case may be, during the months in the taxable year of the estate or trust ending within the taxable year of the beneficiary which precede the month in which the installment date falls. See subparagraph (2) of this paragraph for examples of a similar rule which is applied when a partner and the partnership of which he is a member have different taxable years.

(e) *Special rule in case of change from joint return or separate return for the preceding taxable year*—(1) *Joint return to separate returns.* In determining the applicability of the exceptions described in paragraph (a)(1) and (4) of this section to an underpayment of estimated tax, a taxpayer filing a separate return who filed a joint return for the preceding taxable year shall be subject to the following rule: The tax—

(i) Shown on the return for the preceding taxable year, or

(ii) Based on the tax rates and personal exemptions for the current taxable year but otherwise determined on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year,

shall be that portion of the tax which bears the same ratio to the whole of the tax as the amount of the tax for which the taxpayer would have been liable bears to the sum of the taxes for which the taxpayer and his spouse would have been liable had each spouse filed a separate return for the preceding taxable year. For rules with respect to the allocation of joint payments of estimated tax, see section 6015(b) and § 1.6015(b)-1(b).

(2) *Examples.* The rule in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). H and W filed a joint return for the calendar year 1955 showing taxable income of $20,000 and a tax of $5,280. Of the $20,000 taxable income, $18,000 was attributable to H, and $2,000 was attributable to W. H and W filed separate returns for 1956. The tax shown on the return for the preceding taxable year, for purposes of determining the applicability of the exception described in paragraph (a)(1) of this section to an underpayment of estimated tax by H for 1956, is determined as follows:

Taxable income of H for 1955	$18,000
Tax on $18,000 (on basis of separate return)	$ 6,200
Taxable income of W for 1955	$ 2,000
Tax on $2,000 (on basis of separate return)	$ 400
Aggregate tax of H and W (on basis of separate returns)	$ 6,600
Portion of 1955 tax shown on joint return attributable to H (6200/6600 × 5280)	$ 4,960

Example (2). Assume the same facts as in example (1) and that H and W file a joint declaration of estimated tax for 1956 and pay estimated tax in amounts determined on the basis of their eligibility for three rather than two exemptions for 1956. H and W ultimately file separate income tax returns for 1956. Assume further that the exception described in paragraph (a)(1) of this section does not apply. The tax based on the tax rates and personal exemptions for 1956 but otherwise determined on the basis of the facts shown on the return for 1955 and the law applicable to 1955, for purposes of determining the applicability of the exception described in paragraph (a)(4) of this section to an underpayment of estimated tax by H for 1956, is determined as follows:

Taxable income of H and W for 1955 based on additional personal exemption for 1956	$19,400
Tax on 1955 income based on joint return rate for 1956	$ 5,076
Portion of 1955 tax attributable to H (computed as in example (1) but allowing benefit of additional exemption to H)	5900/6300
Portion of tax attributable to H based on tax rates and personal exemptions for 1956 but otherwise on facts on 1955 return (5900/6300 × $5,076)	$ 4,754

Example (3). Assume that H and W had the same taxable income in 1972 as in 1955, and that they filed a joint return for 1972 and separate returns for 1973. Assume further that H's taxable income for 1972 included net earnings from self-employment in excess of the $9,000 maximum base for the self-employment tax for 1972, and that the joint return filed by H and W for 1972 showed tax under chapter 1 (other than section 56) and tax under chapter 2 totaling $5,055. The tax shown on the return for 1972, for purposes of determining the applicability of the exception described in paragraph (a)(1) of this section to an underpayment of estimated tax by H for 1973, is determined as follows:

Taxable income of H for 1972	$18,000	
Chapter 1 tax (other than section 56 tax) on $18,000 (on basis of separate return)		$5,170
Self-employment income of H for 1972	$ 9,000	
Chapter 2 tax on $9,000		675
Total of such taxes		$5,845
Taxable income of W for 1972	$ 2,000	
Chapter 1 tax (other than section 56 tax) on $2,000 (on basis of separate return)		310
Aggregate tax of H and W (on basis of separate returns)		$6,155
Portion of 1972 tax shown on joint return attributable to H (5845/6155 × $5,055)		$4,800.40

(3) *Separate return to joint return.* In the case of a taxpayer who files a joint return for the taxable year with respect to which there is an underpayment of estimated tax and who filed a separate return for the preceding taxable year—

(i) The tax shown on the return for the preceding taxable year, for purposes of determining the applicability of the exception described in paragraph (a)(1) of this section, shall be the sum of both the tax shown on the return of the taxpayer and the tax shown on the return of the taxpayer's spouse for such preceding year, and

(ii) The facts shown on both the taxpayer's return and the return of his spouse for the preceding taxable year shall be taken into account for purposes of determining the applicaparagraph (a)(4) of this section.
bility of the exception described in

(4) *Example.* The rules described in subparagraph (3) of this paragraph may be illustrated by the following example:

Example. H and W filed separate income tax returns for the calendar year 1954 showing tax liabilities of $2,640 and $350, respectively. In 1955 they married and participated in the filing of a joint return for that year. Thus, for the purposes of determining the applicability of the exceptions described in paragraph (a)(1) and (4) of this section to an underpayment of estimated tax for the year 1955, the tax shown on the return for the preceding taxable year is $2,990 ($2,640 plus $350).

Par. 14. Section 1.6654-3 is amended by revising paragraph (b) to read as follows:

§ 1.6654-3 Short taxable years of individuals.

* * * * *

(b) *Rules as to application of section 6654(d).*

(1) In any case in which the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in determining the tax—

(i) Shown on the return for the preceding taxable year (for purposes of section 6654(d)(1)), or

(ii) Based on the personal exemptions and rates for the current taxable year but otherwise on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year (for purposes of section 6654(d)(4)), the tax will be reduced by multiplying it by the number of months in the short tax-

able year and dividing the resulting amount by 12.

(2) If the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in annualizing the taxable income for the months in the taxable year preceding an installment date, for purposes of section 6654(d)(2), the personal exemptions allowed as deductions under section 151 shall be reduced to the same extent that they are reduced under section 443(c) in computing the tax for a short taxable year.

(3) If "the preceding taxable year" referred to in section 6654(d)(4) was a short taxable year, for purposes of determining the applicability of the exception described in section 6654(d)(4), the tax, computed on the basis of the facts shown on the return for the preceding year, shall be the tax computed on the annual basis in the manner described in section 443(b)(1) (prior to its reduction in the manner described in the last sentence thereof). If the tax rates or the taxpayer's status with respect to personal exemptions for the taxable year with respect to which the underpayment occurs differs from such rates or status applicable to the preceding taxable year, the tax determined in accordance with this subparagraph shall be recomputed to reflect the rates and status applicable to the year with respect to which the underpayment occurs.

REGULATIONS AND PROCEDURE AND ADMINISTRATION (26 CFR Part 301)

Par. 15. Section 301.6015-1 is amended to read as follows:

§ 301.6015-1 Declaration of estimated income tax by individuals.

For provisions relating to requirements of declarations of estimated income tax by individuals, see § 1.6015 of this chapter (Income Tax Regulations).

Par. 16. Section 301.6211 is amended by revising subsection (b)(1) of section 6211 and by adding a historical note. The amended and added provisions read as follows:

§ 301.6211 Statutory provisions; definition of a deficiency.

Sec. 6211. *Definition of a deficiency.* ***

(b) *Rules for application of subsection (a).* For purposes of this section—

(1) The tax imposed by subtitle A and the tax shown on the return shall both be determined without regard to payments on account of estimated tax, without regard to the credit under section 31, and without regard to so much of the credit under section 32 as exceeds 2 percent of the interest on obligations described in section 1451.

* * * * *

[Section 6211 as amended by sec. 102(b)(4), Tax Adjustment Act 1966 (80 Stat. 64) [Pub. L. 89-368, 1966-1 C.B. 379]]

Par. 17. Section 301.6654 is amended by revising subsections (a), (b), (d) and (f) of section 6654 and by revising the historical note. The amended provisions read as follows:

§ 301.6654 Statutory provisions; failure by individual to pay estimated income tax.

Sec. 6654. *Failure by individual to pay estimated income tax*—(a) *Addition to the tax.* In the case of any underpayment of estimated tax by an individual, except as provided in subsection (d), there shall be added to the tax under chapter 1 and the tax under chapter 2 for the taxable year an amount determined at an annual rate established under section 6621 upon the amount of the underpayment (determined under subsection (b)) for the period of the underpayment (determined under subsection (c).

(b) *Amount of underpayment.* For purposes of subsection (a), the amount of the underpayment shall be the excess of—

(1) The amount of the installment which would be required to be paid if the estimated tax were equal to 80 percent (66⅔ percent in the case of individuals referred to in section 6073(b), relating to income from farming or fishing) of the tax shown on the return for the taxable year or, if no return was filed, 80 percent (66⅔ percent in the case of individuals referred to in section 6073(b), relating to income from farming or fishing) of the tax for such year, over

(2) The amount, if any, of the installment paid on or before the last date prescribed for such payment.

* * * * *

(d) *Exception.* Notwithstanding the provisions of the preceding subsections, the addition to the tax with respect to any underpayment of any installment shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceeds the amount which would have been required to be paid on or before such date if the estimated tax were whichever of the following is the least—

(1) The tax shown on the return of the individual for the preceding taxable year, if a return showing a liability for tax was filed by the individual for the preceding taxable year and such preceding year was a taxable year of 12 months.

(2) An amount equal to 80 percent (66⅔ percent in the case of individuals referred to in section 6073(b), relating to income from farming or fishing) of the tax for the taxable year computed by placing on an annualized basis the taxable income for the months in the taxable year ending before the month in which the installment is required to be paid and by taking into account the adjusted self-employment income (if the net earnings from self-employment (as defined in section 1402(a)) for the taxable year equal or exceed $400). For purposes of this paragraph—

(A) The taxable income shall be placed on an annualized basis by—

(i) Multiplying by 12 (or, in the case of a taxable year of less than 12 months, the number of months in the taxable year) the taxable income (computed without deduction of personal exemptions) for the months in the taxable year ending before the month in which the installment is required to be paid,

(ii) Dividing the resulting amount by the number of months in the taxable year ending before the month in which such installment date falls, and

(iii) Deducting from such amount the deductions for personal exemptions allowable for the taxable year (such personal exemptions being determined as of the last date prescribed for payment of the installment).

(B) The term "adjusted self-employment income" means—

(i) The net earnings from self-employment (as defined in section 1402(a)) for the months in the taxable year ending before the month in which the installment is required to be paid, but not more than

(ii) The excess of (I) an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which the taxable year begins, over (II) the amount determined by placing the wages (within the meaning of section 1402(b)) for the months in the taxable year ending before the month in which the installment is required to be paid on an annualized basis in a manner

consistent with clauses (i) and (ii) of subparagraph (A).

(3) An amount equal to 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income and the actual self-employment income for the months in the taxable year ending before the month in which the installment is required to be paid as if such months constituted the taxable year.

(4) An amount equal to the tax computed, at the rates applicable to the taxable year, on the basis of the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on his return for, and the law applicable to, the preceding taxable year.

* * * * *

(f) *Tax computed after application of credits against tax.* For purposes of subsection (b) and (d), the term "tax" means—

(1) The tax imposed by this chapter 1 (other than by section 56), plus

(2) The tax imposed by chapter 2, minus

(3) The credits against tax allowed by part IV of subchapter A of chapter 1, other than the credit against tax provided by section 31 (relating to tax withheld on wages).

* * * * *

[Sec. 6654 as amended by sec. 1(a)(4), Act of Sept. 25, 1962 (Pub. Law 87-682, 76 Stat. 575) [1962-3, C.B. 68]; secs. 102 (b)(1), (2), (3) and 103(a), Tax Adjustment Act 1966 (80 Stat. 62, 64) [Pub. L. 89-368, 1966-1 C.B. 379]; sec. 301(b) (13), Tax Reform Act 1969 (83 Stat. 586) [Pub. L. 91-172, 1969-3 C.B. 10]; sec. 203 (b)(7), Act of March 17, 1971 (Pub. Law 92-5, 85 Stat. 11) [1971-1 C.B. 553]; sec. 203(b)(7), Act of July 1, 1972 (Pub. Law 92-336, 86 Stat. 420) [1972-2 C.B. 672]; sec. 203(b)(7) and (d), Act of July 9, 1973 (Pub. Law 93-66, 87 Stat. 153) [1973-2 C.B. 439]; sec. 5(b)(7), Act of Dec. 31, 1973 (Pub. Law 93-233, 87 Stat. 954) [1974-1 C.B. 380); sec. 7(c), Act of Jan. 3, 1975 (Pub. Law 93-625, 88 Stat. 2115) [1975-1 C.B. 510]]

Because the portion of the amendment made by this Treasury decision to § 301.6654 which was not included in the notice of proposed rule making published in the Federal Register for January 6, 1975, is merely clerical in nature, it is hereby found that it is unnecessary to issue such portion of that amendment with notice and public procedure thereon under section 553(b) of title 5 of the United States Code, or subject to the effective date limitation of subsection (d) of such section.

(This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).)

DONALD C. ALEXANDER
Commissioner of
Internal Revenue.

Approved July 29, 1976.

CHARLES M. WALKER,
Assistant Secretary
of the Treasury.

(Filed by the Office of the Federal Register on August 9, 1976, 4:15 p.m., and published in the issue of the Federal Register for August 12, 1976, 41 F.R. 34025)

Section 6655.—Failure By Corporation to Pay Estimated Income Tax

26 CFR 1.6655-2: Exceptions to imposition of the addition to the tax in the case of corporations.
(Also Section 461; 1.461-1)

Estimated tax penalty; annualized income; accrued tax expense. The state property tax and franchise tax deducted in full on the lien date or the accrual date by a corporation under its method of accounting may be deducted in computing annualized taxable income for purposes of section 6655(d)(3) of the Code; however, an accrual method taxpayer accruing real property taxes ratably under section 461 may only deduct the accrued ratable portion for the period for which taxable income is being annualized.

Rev. Rul. 76-450

Advice has been requested whether, under the circumstances described below, the taxpayer can deduct state property taxes in full on the lien date and the franchise tax in full on the accrual date in computing annualized taxable income for the purpose of determining whether the exception to the addition to the tax for underpayment of estimated tax provided by section 6655(d)(3) of the Internal Revenue Code of 1954 is applicable.

The taxpayer, a corporation, files its Federal income tax returns on a calendar year basis. The taxpayer's state franchise tax is based on the net income it received during the previous calendar year. The taxpayer's state property taxes are imposed on a fiscal year basis beginning July 1, and become a lien on March 1 prior to the beginning of the fiscal year. Under the taxpayer's accounting method, for Federal income tax purposes, property taxes and the franchise tax are deducted in full on the accrual date. The accrual date for the state property taxes is March 1, the lien date.

Section 6655(a) of the Code provides that in the case of any underpayment of estimated tax by a corporation, except as provided in subsection (d), there shall be added to the tax under Chapter 1 for the taxable year an amount determined at an annual rate established under section 6621.

Section 6655(d)(3) of the Code provides that the addition to the tax with respect to any underpayment of any installment shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceeds the amount which would have been required to be paid on or before such date if the estimated tax were an amount equal to 80 percent of the tax for the taxable year computed by placing on an annualized basis the taxable income for the first 3, 5, 6, 8, 9, or 11 months of the taxable year.

Section 6655(e) of the Code defines tax, for the purpose of section 6655 (d), as the excess of the income tax imposed on corporations by section 11 or 1201(a) over the credits against tax provided by Part IV of subchapter A of chapter 1. State franchise taxes and

state real estate taxes are deductible in arriving at taxable income on which the tax imposed by section 11 of the Code is determined.

The regulations under section 6655 of the Code do not specifically refer to the proper date for deducting state property and franchise taxes. However, section 1.6655-2(d) of the Income Tax Regulations does refer to section 1.6654-2(d)(1) of the regulations under section 6654(d)(2)(A), the counterpart of section 6655(d)(3), relating to individuals. Section 1.6654-2(d) provides that in determining the taxable income applicable to an installment period, deductions are not allowable until paid or accrued depending on the taxpayer's method of accounting.

Accordingly, since under the taxpayer's accounting method, for Federal income tax purposes state property taxes and the franchise tax are deducted in full on the accrual date, such taxes are deductible in full in computing annualized taxable income for the purpose of determining the applicability of the exception provided by section 6655(d)(3) of the Code to the addition to the tax for underpayment of estimated tax by the taxpayer. If, on the other hand, the taxpayer uses the accrual method of accounting and accrues real property taxes ratably under section 461(c), the taxpayer cannot take a deduction in computing annualized taxable income under section 6655(d)(3) for the full amount of real estate taxes accrued on March 1. The corporation accruing its real property taxes ratably may deduct only that amount that has accrued ratably during the period for which the taxable income is being annualized.

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26 CFR 1.6655-2: Exceptions to imposition of the addition to the tax in the case of corporations.
(Also Section 6154; 1.6154-1)

Estimated tax; corporations; additions to tax for underpayment. A calendar year corporation receiving most of its income during the last six months of the year and making only one installment payment of estimated tax, a timely fourth installment period payment equal to 25 percent of 80 percent of its ultimate tax liability for the year, has not underpaid the installment due for the fourth period within the meaning of section 6655 of the Code.

Rev. Rul. 76-563

Advice has been requested whether, under the circumstances described below, there is an underpayment of the estimated tax installment due from a corporation on the fifteenth day of the last month of a calendar year within the meaning of section 6655(b) of the Internal Revenue Code of 1954.

X is a corporation that files its Federal income tax returns on a calendar year basis. Due to the seasonal nature of its business, most of *X*'s income is earned during the last six months of the year. *X* did not make any installment payments of estimated tax during 1975 until December 15. On December 15, 1975, *X* paid an amount equal to 25 percent of 80 percent (i.e., 20 percent) of the tax liability that was ultimately reflected on its Federal income tax return for the calendar year.

Section 6154(a) of the Code provides that every corporation subject to taxation under section 1 or 1201(a) shall make payments of estimated tax (as defined in subsection (c)) during its taxable year if its estimated tax for such year can reasonably be expected to be $40 or more. Section 6154(b) provides that if the requirements of subsection (a) are met before the first day of the fourth month, 25 percent of the estimated tax shall be paid on the 15th day of the fourth, sixth, ninth, and twelfth months of the taxable year.

Section 6655 of the Code provides, with exceptions not applicable here, for an addition to the tax in the case of any underpayment of estimated tax by a corporation.

Section 6655(b) of the Code defines an underpayment as the excess of (1) the amount of the installment which would be required to be paid if the estimated tax were equal to 80 percent of the tax shown on the return for the taxable year or, if no return was filed, 80 percent of the tax for such year, over (2) the amount, if any, of the installment paid on or before the last date prescribed for payment.

Section 6655(c)(2) of the Code provides that for purposes of determining the period of underpayment, a payment of estimated tax on any installment date shall be considered a payment of any previous underpayment only to the extent such payment exceeds the amount of the installment determined under subsection (b)(1) for such installment date.

In the instant case, *X* is required under section 6154 of the Code to make installment payments of estimated tax for each installment period of its tax year. Its fourth installment of estimated tax is required to be 25 percent of the total estimated tax for the year.

Under the provisions of section 6655(c)(2) of the Code any payment remitted on the due date for the fourth installment of estimated tax is considered a payment for that period and only the excess over the amount determined under section 6655(b)(1) is then applied to a prior period. The entire payment made on or before the due date for the fourth installment (but subsequent to the due date for the third installment) of estimated tax is considered an amount paid with respect to the liability arising in the fourth period.

Accordingly, since *X*'s estimated tax payment for the fourth period is equal to the amount required for that period (25 percent of the 80 percent of the tax liability for the year), there is no underpayment of estimated tax for the fourth period within the

meaning of section 6655(b) of the Code.

Chapter 74.—Closing Agreements and Compromises

Section 7121.—Closing Agreements

26 CFR 301.7121-1: Closing agreements.

Rev. Proc. 76-4 is modified to provide a new effective date for section 367 rulings issued in conjunction with the closing agreements described therein. See Rev. Proc. 76-44, page 668.

Chapter 75.—Crimes, Other Offenses, and Forfeitures
Subchapter A.—Crimes
Part I.—General Provisions

Section 7206.—Fraud and False Statements

Ct. D. 1981

SUPREME COURT OF THE UNITED STATES

No. 75-1667

United States, Petitioner v.
Peter Pomponio et al.
[429 U.S. 10]

On petition for writ of certiorari to the United States Court of Appeals for the Fourth Circuit

[October 12, 1976]

PER CURIAM.

After a jury trial, respondents were convicted of willfully filing false income tax returns, in violation of 26 U.S.C. § 7206(1).[1] Based on its reading of *United States* v. *Bishop*, 412 U.S. 346 (1973) [1973-2 C.B. 417], the Court of Appeals held that the jury was incorrectly instructed concerning willfulness, and remanded for a new trial. 528 F. 2d 247 (CA4 1975). The United States petitioned for certiorari. We reverse.

The respondents were charged with falsifying tax returns in two principal ways: (1) they allegedly caused corporations they controlled to report payments to them as loans, when they knew the payments were really taxable dividends; and (2) they allegedly claimed partnership losses as deductions knowing that the losses were properly attributable to a corporation. Their defense was that these transactions were correctly reported, or at least that they thought so at the time.

The jury was instructed that respondents were not guilty of violating § 7206(1) unless they had signed the tax returns knowing them to be false,[2] and had done so willfully. A willful act was defined in the instructions as done "voluntarily and intentionally with the specific intent to do something which the law forbids, that is to say with [the] bad purpose either to disobey or to disregard the law." Finally, the jury was instructed that "[g]ood motive alone is never a defense where the act done or omitted is a crime," and that consequently motive was irrelevant except as it bore on intent. The Court of Appeals held this final instruction improper because "the statute at hand requires a finding of bad purpose or evil motive." 528 F. 2d, at 249. In so holding, the Court of Appeals incorrectly assumed that the reference to an "evil motive" in *United States* v. *Bishop, supra*, and prior cases meant something more than the specific intent to violate the law described in the trial judge's instruction.

In *Bishop* we held that the term "willfully" has the same meaning in the misdemeanor and felony sections of the Revenue Code and that it requires more than a showing of careless disregard for the truth.[3] We did not, however, hold that the term requires proof of any motive other than an intentional violation of a known legal duty. We explained the meaning of willfulness in § 7206 and related statutes:

"The Court, in fact, has recognized that the word 'willfully' in these statutes generally connotes a voluntary, intentional violation of a known legal duty. It has formulated the requirement of willfulness as 'bad faith or evil intent,' [*United States* v.] *Murdock*, 290 U.S. [389] [XIII-1 C.B. 144 (1934] at 398, or 'evil motive and want of justification in view of all the financial circumstances of the taxpayer,' *Spies* [v. *United States*] 317 U.S. [492] [1943 C.B. 1038] at 498, or knowledge that the taxpayer 'should have reported more income than he did.' *Sansone* [v. *United States*], 380 U.S. [343] [1965-2 C.B. 451] at 353. See *James* v. *United States*, 366 U.S. 213, 221 (1961) [1961-2 C.B. 9]; *McCarthy* v. *United States*, 394 U.S. 459, 471 (1969)." 412 U.S., at 360.

Our references to other formulations of the standard did not modify the standard set forth in the first sentence

[1] Section 7206 provides:
"Any person who
"(1) . . . . Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter . . .

* * * * *

"shall be guilty of a felony . . . ."

[2] We agree with the Court of Appeals that the instructions on this point were "full and complete." 528 F. 2d, at 249-250. The jury was told the government contended that respondents "couldn't claim this [the partnership losses] as a deduction . . . because by so doing they would know that they were filing a false report of their total gross income." Later the jury was instructed that, if they found the loans were incorrectly reported, they must also find that the return was "made willfully and with the specific intent and knowledge at the time they made it that it was in fact a false return." In explaning intent, the trial judge said that "[t]o establish the specific intent the Government must prove that these defendants knowingly did the acts, that is, filing these returns, knowing that they were false, purposely intending to violate the law." The jury was told to "bear in mind the sole charge that you have here, and that is the violation of 7206, the willfull making of the false return, and subscribing to it under perjury, knowing it not to be true and to [*sic*] all material respects, and that and that alone."

[3] The Court of Appeals in *Bishop* held that the evidence under the misdemeanor statute "need only show unreasonable, capricious, or careless disregard for the truth or falsity of income tax returns field." 455 F. 2d 612, 615 (CA9 1972). This Court rejected the view that this lesser degree of culpability was required for a violation of the misdemeanor statute, and held on the contrary that "Congress used the word 'willfully' to describe a constant rather than a variable in the tax penalty formula." 412 U.S., at 359-360.

of the quoted paragraph. On the contrary, as the other courts of appeals to consider the question have recognized, willfulness in this context simply means a voluntary, intentional violation of a known legal duty. *United States* v. *Pohlman*, 522 F. 2d 974, 977 (CA8 1975) (en banc), cert. denied, 423 U.S. 1049; *United States* v. *McCorkle*, 511 F. 2d 482, 484-485 (CA7 1975) (en banc), cert. denied, 423 U.S. 826; *United States* v. *Greenlee*, 517 F. 2d 899, 904 (CA3 1975), cert. denied, 423 U.S. 985; *United States* v. *Hawk*, 497 F. 2d 365, 366-369 (CA9 1974), cert. denied, 419 U.S. 838. The trial judge in the instant case adequately instructed the jury on willfulness. An additional instruction on good faith was unnecessary.

As an alternate ground for ordering a new trial, the Court of Appeals held that respondents were entitled to instructions exonerating them if they believed that the payments to them were loans and that the losses belonged to the partnership, 528 F. 2d, at 250. Our inspection of the record indicates that such instructions were given and that they were adequate.[4]

The respondents' other allegations of error which the Court of Appeals found it unnecessary to reach should be considered by that court in the first instance.

The judgment of the Court of Appeals is reversed and the case remanded for further proceedings consistent with this opinion.

[4] The instructions set forth in n. 2, *supra*, by requiring knowledge that the returns falsely reported the transactions, implicitly required knowledge of the true nature of the transactions. In addition, the jury was instructed with respect to the loans that "if you do find that they were not bona fide loans then you must next determine whether or not the defendants knew at the time they were withdrawing this money that it was not a loan. . . . In other words, you should determine whether they knew that, and as I have told you, that is an essential element." With respect to the partnership losses, the jury was told that the government claimed that respondents "knew that they couldn't transfer [a certain asset] to a partnership, and, therefore, when they couldn't transfer it they couldn't take the benefits of any losses sustained by the partnership in question. . . ."

Chapter 76.—Judicial Proceedings
Subchapter B.—Proceedings by Taxpayers and Third Parties

Section 7425.—Discharge of Liens

26 CFR 301.7425: Statutory provisions; discharge of liens.

Rules relating to discharge of liens and redemption of real property by the United States. See T.D. 7430, page 314.

Chapter 77.—Miscellaneous Provisions

Section 7506.—Administration of Real Estate Acquired by the United States

26 CFR 301.7506-1: Administration of real estate acquired by the United States.

Whether the voluntary transfer of real property to the Federal Govenment is an acceptable method of payment of Federal taxes under the provisions of the Code. See Rev. Rul. 76-350, page 396.

Section 7508.—Time for Performing Certain Acts Postponed By Reason of Service in Combat Zone

(Also Section 6072; 1.6072-1.)

Individual in combat zone; time for performing certain acts. The last date for the timely performance of the acts enumerated in section 7508 of the Code, relating to an individual serving in a combat zone, is determined by adding to the time to be disregarded under section 7508 the time which remained for the performance of such acts at the time the individual entered the combat zone.

Rev. Rul. 76-425

Advice has been requested concerning the time to be disregarded in determining whether the performance of certain acts during a period of combatant activities is timely.

Section 7508 of the Internal Revenue Code of 1954 provides that the time an individual is serving in, or in support of, the Armed Forces of the United States in an area designated by the President of the United States by Executive order as a "combat zone" for purposes of section 112, and the next 180 days thereafter, shall be disregarded in determining whether certain specified acts, such as the filing of returns, paying of taxes, filing a petition with the Tax Court, filing a claim for credit or refund, bringing suit, assessing tax, etc., are performed within the time prescribed therefor.

Any unexpired portion of the time prescribed for the performance of an act enumerated in section 7508 of the Code, which existed at the time the individual entered the combat zone, is to be added to the time to be disregarded under section 7508 when determining the last day for the timely performance of such an act.

Accordingly, for the purpose of determining the last date for the timely performance of any of the acts enumerated in section 7508 of the Code, the unexpired portion of the time prescribed for the performance of such act, which existed at the time the individual entered the combat zone, shall be added to the time to be disregarded under section 7508.

Example: A taxpayer served in a combat zone between February 12, 1970, and November 15, 1972. The taxpayer would have been required to file an individual income tax return for the year 1969 on April 15, 1970, had the taxpayer not been serving in a combat zone on that date. The computation of the period of time which the taxpayer has to file a timely individual tax return for 1969 is as follows:

(a) 180 days after November 15, 1972, plus,

(b) 63 days thereafter attributable to the unexpired time to file a return for 1969 at the time the taxpayer began serving in the combat zone.

Thus, the taxpayer was required to

file an individual income tax return for 1969 on July 16, 1973.

Treatment of amounts withheld or deducted from the compensation of any individual who dies while in active service in a combat zone as a member of the Armed Forces. See Rev. Rul. 76-355, page 201.

Date of death, for members of the Armed Forces of the United States and civilian employees who are prisoners of war or missing in action, for purposes of the postponement, by reason of war, of the time for performing certain acts. See Rev. Rul. 76-468, page 202.

Chapter 79.—Definitions

Section 7701.—Definitions

26 CFR 301.7701-1: Classification of organizations for tax purposes.

Classification; financing arrangement between U.S. agency and bank. A contractual arrangement between a U.S. agency and a bank, under which the bank sells participating certificates in a trust created by the agency, receives moneys, holds assets, and makes payments on behalf of the U.S. for the purpose of constructing public buildings and satisfying the obligation of the U.S. to holders of the participating certificates, is a security arrangement and not a trust for Federal income tax purposes.

Rev. Rul. 76-265

Advice has been requested whether the arrangement described below is a trust for Federal income tax purposes.

An agency of the United States initiated a statutorily authorized program for financing the construction of certain public buildings on land owned by the United States. Under the program, the agency issued invitations for competitive bids and entered into a contract with the successful bidder to construct the public buildings. To obtain the necessary financing, the agency contracted with a bank to sell, by competitive bidding, participating certificates in a trust created by the agency. The bank was designated as the trustee of the trust. The certificates, which are interest bearing, were issued in fully registered form and are redeemable at the end of a specified period, or earlier, at the option of the United States. Initial purchasers of the offering were required to purchase an entire series of certificates. However, since the certificates are freely transferable, individual certificates were reoffered for sale to the general public by the initial purchasers.

The proceeds from the sale of the certificates to the initial bidders were held by the bank trustee for payment of the costs of constructing the buildings and for other related costs and expenses under the direction of the agency. The trust indenture provides that the United States is unconditionally obligated to pay the costs of the project and that the participation certificates are evidence of undivided interests in such obligation. Thus, the participation certificates are absolute and unconditional general obligations of the United States.

Under the trust agreement, the United States will pay annual amounts to the bank trustee for a period of not more than thirty years from the date that the participation certificates were originally purchased. The payments received from the United States are used by the trustee to establish and to maintain a sinking fund for the retirement of the certificates, to make the principal and interest payments to the certificate holders, to pay the current costs and expenses of the trust, and to pay any amounts due when the principal indebtedness is retired and the trust is terminated. Moneys temporarily held by the trustee are invested only in United States Government bonds as directed by the agency.

The bank trustee will hold title to the buildings and other assets and lease the land on which the buildings are located from the United States at a nominal rental during the period the trust remains in existence. On termination of the trust, full title to the buildings and other assets will vest in the United States.

Other than amounts required to be paid to the certificate holders in satisfaction of the obligation of the United States, all property and money received, held, or paid by the trustee are received, held, or paid for the benefit of the United States. The only income of the trust is interest from United States Government bonds and is included among the assets held for use by the trustee. Thus, the United States is both the payor of the income received by the trustee and the beneficial owner thereof.

Section 301.7701-4(a) of the Procedure and Administration Regulations defines an ordinary trust as an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

In the instant case, the bank trustee will not take title to the property for the purpose of protecting or conserving it for beneficiaries, but will be acting as an agent of the United States and in that capacity will receive moneys, hold assets, and make payments on behalf of the United States for the purposes of constructing public buildings and satisfying the obligation of the United States to holders of the participating certificates.

Accordingly, the arrangement is not a trust for Federal income tax purposes, but is a security arrangement with the bank trustee acting as an agent on behalf of the United States.

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26 CFR 301.7701-2: Associations, including organizations labeled "corporations".

Whether a limited partnership, taxed as a corporation for Federal income tax purposes is a "United States corporation" as that term is used in Article II(1)(e) of the United States-Federal Republic of Germany Income Tax Convention, as

amended by Protocol. See Rev. Rul. 76-435, page 490.

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26 CFR 301.7701-13: Domestic building and loan association.

Tax treatment of certain debentures issued by small business investment companies and guaranteed by the Small Business Administration. See Rev. Rul. 76-426, page 17.

Chapter 80.—General Rules
Subchapter A.—Application of Internal Revenue Laws

Section 7805.—Rules and Regulations

26 CFR 301.7805-1: Rules and regulations.

Obsolete rulings. Additional rulings relating to excise tax matters are obsoleted.

Rev. Rul. 76-315

Consistent with the program for the review of rulings published in the Internal Revenue Bulletin before 1953 (announced by Rev. Proc. 67-6, 1967-1 C.B. 576), the Internal Revenue Service has undertaken a review of rulings that were published in the Bulletin after 1952. As a result of this post-1952 review, the Service published Rev. Rul. 69-227, 1969-1 C.B. 315, Rev. Rul. 72-622, 1972-2 C.B. 652, and Rev. Rul. 74-624, 1974-2 C.B. 406, which declared obsolete numerous rulings having primary application in the excise tax area.

Upon further review of rulings dealing with the excise tax area, the additional rulings listed below, although not specifically revoked or superseded, have been found to be not determinative with respect to future transactions because (1) the applicable statutory provisions or regulations have been changed; (2) the ruling position is specifically covered by statute, regulations, or a subsequent published position; or (3) the facts set forth are not sufficient to permit application of the current statute and regulations. Accordingly, the rulings listed below are hereby declared to be obsolete.

Rev. Rul. No.	*C.B. Citation*
54-25	1954-1, 258
57-95	1957-1, 365
58-575	1958-2, 889
58-585	1958-2, 770

The purpose of this declaration of obsoleteness is to make clear to all concerned that the above-listed rulings are not determinative with respect to future transactions. It is not the purpose of this Revenue Ruling to determine their applicability to past transactions.

Other rulings published after 1952 relating to excise tax matters will continue to be reviewed to ascertain those that are inapplicable to future transactions.

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26 CFR 301.7805-1: Rules and regulations.

Rev. Rul. 76-564

Rev. Proc. 67-6, 1967-1 C.B. 576, announced a program for the review of rulings published in the Internal Revenue Bulletin before 1953 with the immediate objective of identifying and publishing lists of those rulings that, although not specifically revoked or superseded, are not considered determinative with respect to future transactions.

In accordance with that program and based on a review of rulings relating to income and profits taxes, the ruling listed below is hereby declared obsolete.

Solicitor Memorandum (S.M. or S.) Ruling Series

S.M. (or S.) No.	*C.B. Citation*
5719	V-1, C.B. 281 (1927)

The purpose of this declaration of obsoleteness is to make it clear to all concerned that the above-listed ruling is not determinative with respect to future transactions. It is not the purpose of this Revenue Ruling to determine the applicability of the listed ruling to past transactions.

A further review is being made of other old rulings. Therefore, failure to include any particular ruling in this or previous lists should not be construed as an indication that the ruling necessarily is determinative with respect to future transactions.

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26 CFR 301.7805-1: Rules and regulations.

Rev. Rul. 76-565

Rev. Proc. 67-6, 1967-1 C.B. 576, announced a program for the review of rulings published in the Internal Revenue Bulletin before 1953 with an objective of identifying and publishing lists of those rulings which, although not specifically revoked or superseded, are not considered determinative wtih respect to future transactions.

Consistent with the objectives of that program, the Internal Revenue Service has undertaken a review of certain rulings that were published in the Internal Revenue Bulletin after 1952. The purpose of this Revenue Ruling is to publish a list of post 1952 rulings which, although not specifically revoked or superseded, are not considered determinative with respect to future transactions because (1) the applicable statutory provisions or regulations have been changed or repealed; (2) the ruling position is specifically covered by statute, regulations, or a subsequent published position; or (3) the facts set forth no longer exist or are not sufficient to permit application of the current statute. Accordingly, the rulings listed below are hereby declared to be obsolete:

Rev. Rul. No.	*C.B. Citation*
57-286	1957-1, 497
58-381	1958-2, 58
58-544	1958-2, 43
59-26	1959-1, 29
59-42	1959-1, 47
68-385	1968-2, 53
69-110	1969-1, 203
70-559	1970-2, 36

The purpose of this declaration of obsoleteness is to make clear to all concerned that the above-listed rulings are not determinative with respect to

future transactions. It is not the purpose of this Revenue Ruling to determine their applicability to past transactions.

Failure to include in this list of obsolete rulings any Revenue Ruling published after 1952 should not be taken to imply that such has been determined to have continuing application to future transactions.

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26 CFR 301.7805-1: Rules and regulations.

Rev. Rul. 76-566

Rev. Proc. 67-6, 1967-1 C.B. 576, announced a program for the review of rulings published before 1953 with the immediate objective of identifying and publishing lists of those rulings that, although not specifically revoked or superseded, are not considered determinative with respect to future transactions.

Consistent with the objectives of that program, the Internal Revenue Service has undertaken a review of certain rulings that were published in the Internal Revenue Bulletin after 1952. The purpose of this Revenue Ruling is to publish a list of post-1952 rulings dealing primarily with engineering and corporate reorganization matters that, although not specifically revoked or superseded, are not considered determinative with respect to future transactions because (1) the applicable statutory provisions have been changed or repealed; (2) the ruling position is specifically covered by statute, regulations, or a subsequent published position; or (3) the facts set forth no longer exist or are not sufficient to permit application of the current statute.

Accordingly, the rulings listed below are declared obsolete.

Rev. Rul. No.	*C.B. Citation*
76	1953-1, 176
55-118	1955-1, 320
55-180	1955-1, 358
55-352	1955-1, 372
55-430	1955-2, 276
55-657	1955-2, 276
56-287	1956-1, 186
58-54	1958-1, 181
58-593	1958-2, 920

The purpose of this declaration of obsolescence is to make it clear to all concerned that the above-listed rulings are not determinative with respect to future transactions. It is not the purpose of this Revenue Ruling to determine their applicability to past transactions.

Other rulings published after 1952 relating to engineering and corporate reorganization matters will continue to be reviewed to ascertain those that are inapplicable to future transactions. Therefore, failure to include any particular ruling in the above list should not be construed as an indication that the ruling necessarily is determinative with respect to future transactions.

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26 CFR 301.7805-1: Rules and regulations.

List of Revenue Procedures declared obsolete. See Rev. Proc. 76-46, page 670.

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26 CFR 301.7805-1: Rules and regulations.

Whether the adjustment required by section 472(d) of the Code to the inventory of a taxpayer electing to adopt the LIFO inventory method applies to both goods in inventory that are unsalable at normal prices or unusable in the normal way and normal goods that have been written down to market value for tax purposes. See Rev. Rul. 76-282, page 137.

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26 CFR 301.7805-1: Rules and regulations.

Prospective application of a ruling relating to the proper method of electing to defer and amortize research and experimental expenditures under section 174 of the Code. See Rev. Rul. 76-324, page 77.

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26 CFR 301.7805-1: Rules and regulations.

Prospective application of a ruling relating to excise tax on replacement tires sold pursuant to a manufacturer's warranty. See Rev. Rul. 76-423, page 345.

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26 CFR 301.7805-1: Rules and regulations.

Treatment of daily transportation expenses incurred between an individual's residence and place of work. See Rev. Rul. 76-453, page 86.

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26 CFR 403.1: Disposition of seized personal property.

T.D. 7433

TITLE 26.—INTERNAL REVENUE.—CHAPTER 1, SUBCHAPTER F, PART 403—DISPOSITION OF SEIZED PERSONAL PROPERTY.

DEPARTMENT OF THE TREASURY,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C., 20224.

To Officers and Employees of the Internal Revenue Service and Others Concerned:

Preamble:

The regulations in 26 CFR Part 172 in effect on March 14, 1974 are reinstated, recodified and amended in this document. The allocation of responsibility for administration of the part between the Internal Revenue Service and the Bureau of Alcohol, Tobacco and Firearms and certain procedures taken to accomplish that allocation make this action necessary.

The Bureau of Alcohol, Tobacco and Firearms was established by Treasury Department Order 221 [1972-1 C.B. 777], dated June 6, 1972, effective July 1, 1972, which was published in the Federal Register for June 10, 1972 at 37 FR 11696. The purpose of that order was to transfer the functions, powers and duties of the Internal Revenue Service arising under laws relating to alcohol, tobacco, firearms, and explosives (including the Alcohol, Tobacco and Firearms Division of the Internal Revenue Service) to the Bureau of Alcohol, Tobacco and Firearms. (As subsequently explained, most of the functions, powers and duties of the Internal Revenue Service relating to wagering were later also transferred to the Bureau.)

On March 15, 1974, Treasury De-

cision ATF-9 was published in the Federal Register at 39 FR 9953. That Treasury Decision recodified the regulations from 26 CFR Part 172 and prescribed the recodified regulations as 27 CFR Part 72. However, the Treasury Decision recognized that the Internal Revenue Service would continue to rely on 26 CFR Part 172 and provided:

> The regulations in this part shall supersede regulations in 26 CFR Part 172 insofar as such regulations relate to activities administered by the Bureau of Alcohol, Tobacco, and Firearms. Such regulations shall remain in effect to the extent that they deal with activities administered by the Internal Revenue Service.

Thus, it was intended that the Treasury Decision leave 26 CFR Part 172 in force for the administration of those provisions of the Internal Revenue Code of 1954 (Title 26 of the United States Code) implemented by 26 CFR Part 172 which were not transferred to the Bureau of Alcohol, Tobacco and Firearms.

In recodifying or transferring the regulations related to the activities of the Bureau, the recodified 27 CFR Part 72 generally followed 26 CFR Part 172 but certain changes were made. The changes reflect the new status of the Bureau and a change in Treasury policy, along with changes for such purposes as simplifying terminology and correcting clerical errors.

Under Treasury Department Order 221-3 [1975-1 C.B. 758], dated and effective December 24, 1974, which was published in the Federal Register at 40 FR 1084 for January 6, 1975, the responsibility for the administration and enforcement of the wagering tax laws contained in Chapter 35 of the Internal Revenue Code of 1954 and certain other provisions of the Internal Revenue Code of 1954 as they relate to activities administered and enforced with respect to Chapter 35 were transferred from the Internal Revenue Service to the Bureau of Alcohol, Tobacco and Firearms. That Order was subsequently revised by Treasury Department Order 221-3 (Rev. 1) [1976-1 C.B. 584], dated and effective February 21, 1976, published in the Federal Register at 41 FR 10079 for March 9, 1976. However, the revised Order did not amend the original order in any way pertinent to this Treasury Decision. The responsibility transferred by these Treasury Department Orders included forfeiture matters relating to wagering violations.

In the 1974 publication of the Code of Federal Regulations, Title 26—Internal Revenue Service, Department of the Treasury, revised as of April 1, 1974, 26 CFR Part 172 was inadvertently omitted. Further, Bureau of Alcohol, Tobacco and Firearms regulations (Regs. No. 1) published at 40 FR 16835 on April 15, 1975, effective April 15, 1975, redesignated the regulations formerly codified as 26 CFR Parts 170 through 299 (Subchapter E Alcohol, Tobacco and other Excise Taxes, of Chapter 1) as 27 CFR Parts 170 through 299 (Subchapter M—Alcohol, Tobacco and Other Excise Taxes). The purpose of that redesignation was to assure orderly development of the Code of Federal Regulations (1 CFR 8.2). However, that published document effected the transfer of 26 CFR Part 172 to Title 27 of the Code of Federal Regulations and redesignated that Part as 27 CFR Part 172. This action placed the jurisdiction for the administration of the part in the Bureau.

To the extent that 26 CFR Part 172 related to personal property and carriers seized as subject to forfeiture as being used, or intended to be used, to violate Chapters 35 (wagering), 51 (distilled spirits), 52 (tobacco) and 53 (firearms) of the internal revenue laws (26 U.S.C., and Chapters 35, 51, 52 and 53), administrative responsibility for the part was placed in the Bureau at the time those functions were transferred to that organization. However, the Internal Revenue Service retained, and still has, responsibility for the administration of forfeitures of personal property seized as subject to forfeiture as being used, or intended to be used, to violate the internal revenue laws other than Chapters 35 (wagering), 51 (distilled spirits), 52 (tobacco) and 53 (firearms) (26 U.S.C., Chapters 35, 51, 52 and 53). Regulations implementing that responsibility are necessary.

To correct the omission of 26 CFR Part 172 from the Code of Federal Regulations, as revised April 1, 1974, and the recodification of the part as 27 CFR Part 172, the provisions of 26 CFR Part 172 as they appear immediately prior to March 15, 1974 are hereby reinstated and recodified as 26 CFR Part 403. To reflect accurately the responsibility of the Internal Revenue Service in the administration of 26 CFR Part 403, as reinstated and recodified, it is necessary to amend the part. Also, other technical amendments are necessary. These are discussed below.

CHANGES

The changes described below refer to changes made to old 26 CFR Part 172 which has been recodified in this document as 26 CFR Part 403. Thus, a change described with respect to a section of 26 CFR Part 172 will be reflected in the corresponding section of 26 CFR Part 403. For example, if a change to § 172.1 is discussed below, it will be found in the document at § 403.1. However, in the case of § 403.2 there is no corresponding section of 26 CFR Part 172. Therefore, the change in § 172.2 is reflected in § 403.3, and definitions in §§ 172.5 through 172.20, if not eliminated, are all included in § 403.5 with the exception of the term "commercial crimes" defined in § 403.38.

Necessity for inquiry. Amendments to § 172.38 reflect a change in Treasury policy as contained in the notice of change in policy as to remission and mitigation decisions on vehicle forfeitures issued in the Federal Register

for December 15, 1971 (36 FR 23800) relating to the necessity for inquiry. In addition, § 172.38(b) has been amended by substituting the word "administrative" for the word "summary" and deleting the words "or condemnation."

Changes relating to responsibility of certain officials. The regulations have been amended to change the responsibilities of certain officials. Thus, the term "Commissioner or his delegate" has been substituted for the phrase "duly authorized officers of the Internal Revenue Service" in §172.25; for the term "seizing officer" wherever it appeared in §172.26; for the term "Supervisor in Charge" wherever it appeared in §§ 172.26(a)(3), 172.27, 172.44(b), 172.55, 172.57(c)(2) and 172.65; for the phrase "officers of the Internal Revenue Service concerned" in § 172.38; for the term "Director, Alcohol, Tobacco and Firearms Division" wherever it appeared in §§ 172.43 (a); for the term "Assistant Regional Commissioner" wherever it appeared in §§ 172.43; and for the term "Regional Commissioner" wherever it appeared in § 172.44(b). The term "District Director for the internal revenue district in which the property was seized" has been substituted for the term "Supervisor in Charge" in §§ 172.30, 172.62 and 172.26(a)(6) (now § 403.26(a)(4)), and for the term "Director Alcohol, Tobacco and Firearms Division" in §§172.36 and 172.37. The term "District Director has been substituted for the term "Supervisor in Charge" in § 172.40. The "Director, General Legal Services Division, Office of Chief Counsel, Internal Revenue Service or his delegate" has been substituted for the term "Regional Counsel" in § 172.26(b).

Changes relating to the present responsibility of the Internal Revenue Service for administration. Section 172.1 has been changed to accurately reflect the role of the Internal Revenue Service in the administration of the amended part, § 403.2 has been added to describe the role of the Bureau of Alcohol, Tobacco, and Firearms in the Administration of 27 CFR Part 72 and § 172.2 has been renumbered § 403.3. The definition of "Carrier" has been eliminated because such term is applied only with respect to 49 U.S.C. Chapter 11 seizures which are no longer covered by the part and the term "Carrier" has been stricken wherever it appeared in former §§ 172.26, 172.27, 172.36, 172.38, 172.39, 172.43, 172.44 172.45, 172.55, 172.57, 172.60, 172.61 and 172.62. The term "Director, Alcohol, Tobacco and Firearms Division" has been replaced by the term "Internal Revenue Service." In § 172.25 references to laws other than internal revenue laws not covered by the part have been deleted and the term "internal revenue laws" is modified to make it clear that the part does not extend to property seized with respect to 26 U.S.C. Chapters 35 (wagering), 51 (distilled spirits), 52(tobacco) and 53 (firearms) violations. In § 172.57(c)(2), reference to cigars, cigarettes and cigarette papers and tubes has been deleted and § 172.57(c)(3), which pertains only to such materials, has been deleted. The language in § 172.59 has been deleted because it related to tobacco, and the section has been reserved.

Other changes. In § 172.5 flush material preceding the definitions has been broadened to specifically provide that plural words include singular, and vice versa, that the masculine gender includes the feminine and that the terms "includes" and "including" do not exclude things not enumerated which are in the same general class. Definitions which formerly appeared in §§ 172.6 through 172.20 of carrier; contraband firearms; Director, Alcohol, Tobacco and Firearms Division; supervisor in charge; Assistant Regional Commissioner; IRC; Region; person; reappraisal; Regional Commissioner; and U.S.C. have been eliminated, and § 403.5 provides revised definitions of "appraised value," and "equity." The definition of "commercial crimes" has been deleted from the definition section and added to § 403.38(d) relating to remission and mitigation. It was also changed to simplify terminology and to eliminate the reference to gambling or wagering offenses in order to conform to the Treasury Department's definition of commercial crimes which recognizes that such offenses include "offenses against the revenue laws."

In subparagraphs (1) and (2) of § 172.26(a) the words "and this part" have been added following the words "internal revenue laws" in order to limit the application of the part to internal revenue laws other than those contained in Chapters 35, 51, 52, and 53. Section 172.26(a)(1) has been changed by the addition of the words "except as otherwise provided in this section" to indicate that property which is valued at less than $2,500.00 may be the subject of judicial condemnation proceedings if a bond has been filed with respect to it. Subparagraph (a)(2) has also been amended, in accordance with 26 U.S.C. 7325, to provide that the list of property required thereby be prepared in duplicate. Other minor wording changes have been made to subparagraphs (2) and (3) of paragraph (a). Also in § 172.26(b) the numeral "(1)" has been eliminated, the word "libel" has been replaced by the word "forfeiture" and minor word changes have been made.

Several minor wording changes have been made to §§ 172.27 and 172.28. Further, the word "delivered" has been changed to the word "filed" whenever it occurs. The last sentence has been eliminated because it is repetitious of a sentence in § 172.26(a)(4). In § 172.29, minor wording changes have been made and the reference to United States Savings Bonds has been eliminated as unnecessary.

The heading of § 172.30 has been changed to "Special disposition of perishable goods." The first sentence of such section has been eliminated and

the third sentence has been amended by the inclusion therein of a reference to the appraisal procedures set forth in § 172.26(a)(2). Several minor wording changes have also been made.

In Subpart D, which relates to remission and mitigation, minor wording changes have been made to all sections other than §§ 172.36 and 172.40, and § 172.35 has been amended by the addition of a reference to the applicable customs laws. Section 172.37 has been amended by deleting the term "Department" and substituting therefore the term "Department of the Treasury." In § 172.36, the term "under this part" has been added after the word "forfeiture" in order to limit the application of the part. Section 172.38(b) has been amended by the deletion of the last clause relating to the circumstances of the petitioner which has been incorporated into the new words "and could not have known" which now appear before the phrase "of the seizure." In § 172.38(c), the required statement of the petitioner that he did not intend to defraud the revenue has been changed to a statement that he did not intend that the property be involved or used in violation of the internal revenue laws, which is more in keeping with the wording of section 7302 of the Internal Revenue Code. Section 172.38(d) has been reworded and the definition of "commercial crimes" which was formerly found in the definition section has been included therein. Sections 172.39, 172.41, and 172.42, have been rewritten but no major changes have been made and in § 172.40 the term "internal revenue district" has been substituted for the phrase "the State or other territorial jurisdiction" to better reflect the organizational structure of the Internal Revenue Service.

Paragraph (b) of § 172.43 and paragraphs (a) and (b) of § 172.44 have been amended by the elimination of the numeral (1). Also, § 172.44(b) was amended to make clear that the costs referred to are those incident to the seizure, forfeiture, and sale of the property.

In § 172.50, relating to the rate of compensation of appraisers, the word "day" which formerly appeared immediately after "$3.00 per" has been replaced by the phrase "hour or portion thereof" and the words "and this part" have been added after "internal revenue laws."

In section 172.55, the words "based upon which method in his sound judgment is most advantageous to the best interests of the United States" and the words "advertised for sale, and" have been eliminated. Minor wording changes have also been made to this section as well as § 172.56. In § 172.57(c)(1), the words "and all" and the words "received at public auction and is sealed, competitive bid sales" have been deleted and in § 172.57(c)(2) a minor wording change has been made and a reference to § 172.55 included. In § 172.57(d), the words "offered at public auction or in sealed, competitive bid sales" and "considered to be and treated as" have been eliminated as unnecessary. Section 172.58 has been retitled "Acceptable forms of payment" and the section itself has been changed to recognize this fact. In § 172.60, the words "and authentic" and "on a form to be provided for that purpose" have been deleted. Minor wording changes have been made to §§ 172.61 and 172.62.

It is determined that these amendments are minor and make no substantive change in 26 CFR Part 172 as the part relates to activities of the Internal Revenue Service. Therefore, because the public would not have particular reason to comment, it is found, pursuant to 5 U.S.C. 553(b) that notice and public procedure thereon are unnecessary. Accordingly, 26 CFR Part 172 is reinstated, amended and recodified as 26 CFR Part 403 to read as follows:

PART 403—DISPOSITION OF SEIZED PERSONAL PROPERTY

Reinstatement, recodification, and amendment of regulations:

1. The regulations in this part shall not affect any act done or any liability or right accruing or accrued, or any suit or proceeding had or commenced before the effective date of these regulations.

2. The regulations in this part shall become effective on September 15, 1976.

SUBPART A—SCOPE OF REGULATIONS

Sec.

403.1 Personal property seized by the Internal Revenue Service.
403.2 Personal property seized by the Bureau of Alcohol, Tobacco and Firearms.
403.3 Forms prescribed.

SUBPART B—DEFINITIONS

403.5 Meaning of Terms.

SUBPART C—SEIZURES AND FORFEITURES

403.25 Personal property subject to seizure.
403.26 Forfeiture of seized personal property.
403.27 Type and conditions of cost bond.
403.28 Corporate surety bonds.
403.29 Deposit of collateral.
403.30 Special disposition of perishable goods.

SUBPART D—REMISSION OR MITIGATION OF FORFEITURES

403.35 Laws applicable.
403.36 Interest claimed.
403.37 Form of the petition.
403.38 Contents of the petition.
403.39 Time of filing petition.
403.40 Place of filing.
403.41 Discontinuance of administrative proceedings.
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403.43 Final action.

403.44 Acquisition for official use and sale for account of petitioner in the case of an allowed petition.
403.45 Re-appraisal of property involved in an allowed petition.

SUBPART E—APPRAISER'S FEES

403.50 Rate of compensation.

SUBPART F—ADMINISTRATIVE SALE OF PERSONAL PROPERTY

403.55 Alternative methods of sale.
403.56 All bids on unit basis.
403.57 Conditions of sale.
403.58 Acceptable forms of payment.
403.59 Reserved.
403.60 Purchaser entitled to bill of sale.
403.61 Sale on open, competitive bids.
403.62 Sale on sealed, competitive bids.

SUBPART G—DISPOSAL OF FORFEITED COIN-OPERATED GAMING DEVICES

403.65 Authority for destruction.

Authority: The provisions of this Part 403 are issued under sec. 7805, 68A Stat. 917; 26 U.S.C. 7805, unless otherwise noted.

SUBPART A—SCOPE OF REGULATIONS

§ 403.1 Personal property seized by the Internal Revenue Service.

Regulations in this part relate to personal property seized by officers of the Internal Revenue Service as subject to forfeiture as being involved, used, or intended to be used, as the case may be, in any violation of the internal revenue laws other than Chapters 35 (wagering), 51 (distilled spirits), 52 (tobacco) and 53 (firearms), of the Internal Revenue Code of 1954 (I.R.C.).

§ 403.2 Personal property seized by the Bureau of Alcohol, Tobacco and Firearms.

Regulations in 27 CFR Part 72 relate to personal property seized by officers of the Bureau of Alcohol, Tobacco and Firearms as subject to forfeiture as being involved, used, or intended to be used, as the case may be, in any violation of Chapters 35 (wagering), 51 (distilled spirits), 52 (tobacco) and 53 (firearms), of the I.R.C., as well as certain other federal laws. (Treasury Dept. Order No. 221 (June 6, 1972), 37 F.R. 11696; Treasury Dept. Order No. 221-3 (December 24, 1974), 40 F.R. 1084.)

§ 403.3 Forms prescribed.

The Commissioner of Internal Revenue or his delegate is authorized to prescribe all forms required by or necessary for the administration of this part. Information required by this part shall be furnished in accordance with the instructions issued with respect thereto.

SUBPART B—DEFINITIONS

§ 403.5 Meaning of terms.

As used in this part, and unless the context otherwise requires, the following terms shall have the meanings set forth in this section. In this part words in the plural form shall include the singular, and vice versa, and words importing the masculine gender shall include the feminine. The terms "includes" and "including" do not exclude things not enumerated which are in the same general class.

(a) *Appraised value.* The value placed upon seized property by the appraisers pursuant to § 403.26(a)(2) for the purpose of determining whether the property may be forfeited administratively.

(b) *Equity.* For purposes of Subpart D, the petitioner's interest in the subject personal property at the time of final administrative action on the petition, but not including: (1) any unearned finance charges accruing from the later of the date of seizure or the date of default; (2) any amount rebatable on account of paid insurance premiums; (3) attorney's fees for collection; (4) any amount identified as dealer's reserve; or (5) any amount in the nature of liquidated damages that may have been agreed upon by the buyer and the petitioner.

SUBPART C—SEIZURES AND FORFEITURES

§ 403.25 Personal property subject to seizure.

Personal property may be seized by the Commissioner of Internal Revenue or his delegate for forfeiture to the United States when involved, used, or intended to be used, in violation of the internal revenue laws, other than Chapters 35 (wagering), 51 (distilled spirits), 52 (tobacco) and 53 (firearms) of the I.R.C. (Sec. 7321, 68A Stat. 869; 26 U.S.C. 7321)

§ 403.26 Forfeiture of seized personal property.

(a) *Administrative forfeiture.* (1) Personal property seized as subject to forfeiture under the internal revenue laws and this part which has an appraised value or $2,500.00 or less shall be forfeited to the United States in administrative forfeiture proceedings except as otherwise provided in this section.

(2) If the Commissioner or his delegate seizes personal property which is forfeitable under the internal revenue laws and this part and which in his opinion is valued at $2,500.00 or less, he shall cause a list containing a particular description of the seized property to be prepared in duplicate and an appraisal thereof to be made by three sworn appraisers, selected by the Commissioner or his delegate, who shall be respectable and disinterested citizens of the United States residing within the internal revenue district wherein the seizure was made. Such list and appraisement shall be properly attested by the Commissioner or his delegate and such appraisers.

(3) If such forfeitable personal property is found by the appraisers to be of the value of $2,500.00 or less, the Commissioner or his delegate shall publish a notice once a week for three

consecutive weeks, in some newspaper of the judicial district where property was seized, describing the articles and stating the time, place, and cause of their seizure, and requiring any person claiming them to appear and make such claim within 30 days from the date of the first publication of such notice.

(4) Any person claiming the personal property so seized, within the time specified in the notice, may file with the District Director of the internal revenue district in which the property was seized a claim, stating his interest in the articles seized, and may execute a bond to the United States in the penal sum of $250.00, conditioned that, in case of condemnation of the articles so seized, the obligors shall pay all the costs and expenses of the proceedings to obtain such condemnation. Before the expiration of 10 days after the date on which the claim is filed, the District Director shall transmit such claim, together with the duplicate list or description of the property seized, to the United States Attorney for the district in which such property was seized. Both the claim and the cost bond should be executed in quadruplicate.

(Sec. 7325, 68A Stat. 870, amended; 26 U.S.C. 7325)

(b) *Judicial condemnation.* Personal property seized as subject to forfeiture under the internal revenue laws and this part which has an appraised value of more than $2,500.00 and such seized property which has an appraised value of $2,500.00 or less with respect to which a bond has been filed pursuant to paragraph (a)(4) of this section, shall be forfeited to the United States in judicial condemnation proceedings, as authorized by the Director, General Legal Services Division, Office of Chief Counsel, Internal Revenue Service, or his delegate.

(Sec. 7323, 7325, 7401, 68A Stat. 869, 870, 873, as amended; 26 U.S.C. 7323 7325, 7401)

§ 403.27 Type and conditions of cost bond.

The cost bond filed by a claimant pursuant to § 403.26(a)(4) shall be a corporate surety bond. However, upon a showing to the satisfaction of the Commissioner or his delegate that such claimant is unable to furnish a corporate surety bond, such claimant may file a cost bond with individual sureties acceptable to the Commissioner or his delegate or, in lieu of such cost bond with corporate or individual sureties, he may deposit collateral pursuant to § 403.29.

§ 403.28 Corporate surety bonds.

A corporate surety bond may be filed only if the surety company issuing such bond holds a certificate of authority from the Secretary of the Treasury certifying that such company is an acceptable surety on Federal bonds, subject to the limitations prescribed by Treasury Department Circular 570 as amended.

(Sec. 6, 61 Stat. 648, as amended, sec. 7101, 68A Stat. 847, as amended; 6 U.S.C. 6, 26 U.S.C. 7101)

§ 403.29 Deposit of collateral.

Cash, postal money orders, certified or cashiers' or treasurers' checks, and bonds or notes of the United States, or other obligations which are unconditionally guaranteed as to both interest and principal by the United States, may be pledged and deposited by claimants as collateral security in lieu of corporate surety bonds in accordance with the provisions of Treasury Department Circular No. 154, revised (31 CFR Part 225).

(Sec. 15, 61 Stat. 650, sec. 7101, 68A Stat. 847, as amended; 6 U.S.C. 15, 26 U.S.C. 7101)

§ 403.30 Special disposition of perishable goods.

The proceedings to enforce forfeiture of perishable goods shall, as is the case with proceedings to enforce forfeiture of nonperishable goods, be in the nature of proceedings *in rem* in the United States District Court for the district wherein such seizure is made. When any seized property is liable to perish or become greatly reduced in price or value by keeping, or when it cannot be kept without great expense, the Commissioner or his delegate shall advise the owner, when known, of the seizure thereof. The owner of the seized property may apply to the District Director of the internal revenue district in which the property was seized to examine the property at any time prior to referral of the property to the U.S. Marshal for disposition. If, in the opinion of the Commissioner or his delegate it is necessary that such property be sold to prevent waste or expense, the Commissioner or his delegate shall cause the property to be appraised in accordance with the procedures set forth in § 403.26(a)(2). The owner shall have such property returned to him upon giving a corporate surety bond pursuant to § 403.28 in an amount equal to the appraised value of the property, to abide the final order, decree, or judgment of the court having cognizance of the case. The bond shall be conditioned to pay the amount of the appraised value to the Commissioner or his delegate, the U.S. Marshal, or otherwise, as may be ordered and directed by the court. The bond shall be filed by the Commissioner or his delegate with the U.S. Attorney for the district in which the proceedings may be commenced. If the owner of such property neglects or refuses to give such bond within a reasonable time considering the condition of the property, the Commissioner or his delegate shall request the U.S. Marshal to proceed to sell the property at public sale as soon as practicable and to pay the proceeds of sale, less reasonable costs of the seizure and sale, to the court to abide its final order, decree, or judgment.

(Sec. 7322, 7323, 7324, 68A Stat. 869, 870, as amended; 26 U.S.C. 7322, 7323, 7324)

SUBPART D—REMISSION OR MITIGATION OF FORFEITURES

§ 403.35 Laws applicable.

Remission or mitigation of forfeitures shall be governed by the customs laws applicable to remission or mitigation of penalties as contained in 19 U.S.C. § 1613 and 19 U.S.C. § 1618.

(Sec. 613, 46 Stat. 756, as amended, sec. 618, 46 Stat. 757, as amended, sec. 7327, 68A Stat. 871; 19 U.S.C. 1613, 1618, 26 U.S.C. 7327)

§ 403.36 Interest claimed.

Any person claiming an interest in property seized by an officer of the Internal Revenue Service as subject to administrative forfeiture under this part may file a petition addressed to the District Director of the internal revenue district in which the property was seized for remission or mitigation of the forfeiture of such property.

§ 403.37 Form of the petition.

There is no standardized form provided or required by the Department of the Treasury for use in filing a petition for remission or mitigation of forfeiture. However, the petition should be typewritten on legal size paper; and must be executed under oath, prepared in triplicate, and addressed to the District Director of the internal revenue district in which the property was seized. All copies of original documents submitted as exhibits in support of allegations of the petition should be certified as true and accurate copies of originals. Each copy of the petition must contain a complete set of exhibits.

§ 403.38 Contents of the petition.

(a) *Description of the property.* The petition should contain such a description of the property and such facts of the seizure as will enable the Commissioner or his delegate to identify the property.

(b) *Statement regarding knowledge of seizure.* In the event the petition is filed for the restoration of the proceeds derived from sale of the property pursuant to an administrative forfeiture, it should contain, or be supported by, satisfactory proof that the petitioner did not know and could not have known of the seizure prior to the declaration of forfeiture. (See also § 403.39)

(c) *Interest of petitioner.* The petition should clearly and concisely indicate the nature and amount of his interest in the property on the date the petition is filed, and the facts relied upon to show that the petitioner was not willfully negligent and did not intend that the property be involved or used in violation of the internal revenue laws. Such petition may allege such other circumstances which in the opinion of the petitioner would justify the remission or mitigation of the forfeiture.

(d) *Petitioner innocent party.* If the petitioner did not commit the act which caused the seizure of his property, the petition should state how the property came into the possession of the person whose act did cause the seizure, and it should also state that the petitioner had no knowledge or reason to believe that the property would be involved or used in violation of the internal revenue laws. If the petitioner knows, at the time he files the petition, that the person in whose possession the seized property was at the time of the seizure had a record or reputation for committing commercial crimes, the petitioner should state in the petition whether the petitioner knew of such record or reputation before the petitioner acquired his interest in the property or before such other person came into possession of the property, whichever occurred later. For purposes of this paragraph, the term "commercial crimes" includes, but is not limited to any of the following federal or state crimes:

Offenses against the revenue laws; burglary; counterfeiting; forgery; kidnapping; larceny; robbery; illegal sale or possession of deadly weapons; prostitution (including soliciting, procuring, pandering, white slaving, keeping house of ill fame, and like offenses); extortion; swindling and confidence games; and attempting to commit, conspiring to commit, or compounding any of the foregoing crimes. Addiction to narcotic drugs and use of marihuana will be treated as commercial crimes.

(e) *Documents supporting claim.* The petition should be accompanied by copies, certified by the petitioner under oath as correct, of contracts, bills of sale, chattel mortgages, reports of investigators or credit reporting agencies, affidavits, and any other documents that would support the claims made in the petition.

(f) *Costs.* The petition should contain an undertaking to pay any costs assessed as a condition of allowance of the petition. Such costs include but are not limited to all expenses incurred in seizing and storing the property; the costs borne or to be borne by the United States; the taxes, if any, payable by the petitioner or imposed in respect of the property to which the petition relates; the penalty, if any, asserted by the Internal Revenue Service; and, if the property has been sold, or is in the course of being sold, the expenses incurred relating to such sale.

§ 403.39 Time of filing petition.

A complete petition for remission or mitigation must be filed before the expiration of three months after the sale or other disposition of the property with respect to which the petition is filed. For purposes of this part, the term "sale or other disposition" includes acquisition of the property for official use.

(Sec. 613, 46 Stat. 756, sec. 306, 49 Stat. 880; 19 U.S.C. 1613, 40 U.S.C. 304k)

§ 403.40 Place of filing.

The petition should be filed in triplicate with the District Director for the internal revenue district in which the property was seized.

§ 403.41 Discontinuance of administrative proceedings.

If the petition is filed prior to sale or other disposition of the property, proceedings to effect such sale or other disposition will be discontinued until the petition is either allowed or denied.

§ 403.42 Return of defective petition.

If the petition is defective in some correctable respect, the original of the petition will be returned by letter to the petitioner who will be allowed to submit a corrected petition, in triplicate, within a reasonable time.

§ 403.43 Final action.

(a) *Petitions for remission or mitigation of forfeiture.* (1) The Commissioner or his delegate shall either allow or deny any petition filed pursuant to these regulations. Such allowance or denial will constitute final action. If he allows the petition, the Commissioner or his delegate shall state the conditions, if any, of the allowance.

(2) If he allows the petition, the Commissioner or his delegate may order the property returned to the petitioner, sold for the account of the petitioner, or, pursuant to agreement with the petitioner, acquired for official use.

(3) The Commissioner or his delegate shall notify the petitioner of the allowance or denial of the petition and, in the case of allowance, the conditions, if any, under which the Commissioner or his delegate allowed the petition.

(b) *Offers in compromise of liability to forfeiture.* The Commissioner or his delegate shall accept or reject any offer in compromise of the liability to forfeiture of personal property seized pursuant to § 403.25 and such acceptance or rejection shall be a final action with respect to the offer.

§ 403.44 Acquisition for official use and sale for account of petitioner in the case of an allowed petition.

(a) *Acquisition for official use.* The seized property may be purchased by the United States pursuant to agreement and retained for official use. Where the petitioner is the owner, the purchase price is the appraised value of the property less all costs. Where the petitioner is a creditor, the purchase price is the smaller of: (1) the petitioner's equity, or (2) the appraised value of the property less the amount of all costs.

(b) *Sale for account of petitioner.* If the petitioner elects not to comply with the conditions, if any, set for the return of the property, the Commissioner or his delegate is authorized to sell the property. If the petitioner is the owner of the property, there is deducted from the proceeds of the sale all costs incident to the seizure, forfeiture, and sale. The Commissioner or his delegate shall pay to the petitioner, out of the proper appropriation, an amount equal to the balance, if any. Where the petitioner is a creditor, there is deducted from the proceeds of the sale all costs incident to the seizure, forfeiture, and sale, and the Commissioner or his delegate shall pay to the petitioner, out of the proper appropriation, an amount equal to the smaller of: (1) the balance, if any, or (2) the equity of the petitioner.

§ 403.45 Reappraisal of property involved in an allowed petition.

In determining the nature and extent of the relief to be afforded a petitioner pursuant to § 403.44 the value of the property with respect to which the petition has been allowed is the value of such property as determined by the appraisal thereof made pursuant to § 403.26(a)(2) but if the petitioner desires reappraisal of the property, after notification as to the conditions of allowances of the petition, and makes written request therefor, undertaking in such request to pay, or to be liable for, the total costs of such reappraisal, the property shall be reappraised in the manner in which the original appraisal was made, and the conditions of allowance of the petition shall be modified to the extent required by such reappraisal.

SUBPART E—APPRAISER'S FEES

§ 403.50 Rate of compensation.

Each appraiser selected under § 403.26(a)(2) shall receive compensation of $3.00 per hour or portion thereof for the performance of his duties in appraising property seized as subject to forfeiture under the internal revenue laws and this part.

(Sec. 7325, 68A Stat. 870, as amended; 26 U.S.C. 7325)

SUBPART F—ADMINISTRATIVE SALE OF PERSONAL PROPERTY

§ 403.55 Alternative methods of sale.

When personal property forfeited administratively is to be sold, the Commissioner or his delegate shall cause a notice of sale to be placed in a newspaper of general circulation published in the judicial district wherein the seizure was made. The sale shall occur not less than 10 days from the date of the publication of the notice. At the discretion of the Commissioner or his delegate the forfeited personal property may be sold at public auction to the highest bidder on open, competitive bids, or sold to the highest bidder on sealed, competitive bids.

(Sec. 7325, 68A Stat. 870, as amended; 26 U.S.C. 7325)

§ 403.56 All bids on unit basis.

All competitive bids shall be on a unit basis. Thus, for example, if a number of forfeited automobiles are advertised for sale at the same date, hour and place, whether or not in the same notice of sale, a separate individual bid is required as to each automobile. The Commissioner or his delegate will not accept one blanket bid to cover the entire group of automobiles offered for sale.

§ 403.57 Conditions of sale.

(a) *No recourse.* All personal property to be sold shall be offered for sale "as is" and without recourse against the United States.

(b) *No guarantee.* No guarantee or warranty, expressed or implied, shall be given or understood in respect of any forfeited property offered for sale.

(c) *No sale.* (1) The United States reserves the right to reject any bids.

(2) In a case in which all bids are rejected the Commissioner or his delegate shall readvertise the property for sale in the manner prescribed in § 403.55.

(d) *One bid.* When only one bid is received for a single unit of property such bid shall be the highest bid received for such property.

§ 403.58 Acceptable forms of payment.

The only acceptable forms of payment shall be cash, cashier's check, certified check, or postal money order, in the amount of the accepted bid.

§ 403.59 Reserved.

§ 403.60 Purchaser entitled to bill of sale.

Each purchaser of administratively forfeited property is entitled to receive a suitable bill of sale.

§ 403.61 Sale on open, competitive bids.

If forfeited property is to be sold at public auction to the highest bidder on open, competitive bids, the notice of sale shall so specify, and state the date, hour, and place of such sale.

§ 403.62 Sale on sealed, competitive bids.

If the property is to be sold to the highest bidder on sealed, competitive bids, the notice of sale shall so specify, and shall state the date, hour, and place of sale, and the date, hour, and place prior to the sale when and where prospective bidders may view the property and obtain necessary information. All sealed bids must be filed with the district director of the internal revenue district in which the property was seized before the sale. No bids will be accepted after the sale starts. At the appointed date, hour, and place of sale, all sealed bids timely filed shall be opened in the presence of all bidders attending the sale, who shall have the privilege of inspecting the bids if they so desire.

SUBPART G—DISPOSAL OF FORFEITED COIN-OPERATED GAMING DEVICES

§ 403.65 Authority for destruction.

The Commissioner or his delegate is authorized to order the destruction of any coin-operated gaming device as defined in I.R.C. section 4462 upon which a tax is imposed by I.R.C. 4461, after the expiration of three months from the date of consummation of administrative forfeiture under any provision of the I.R.C.

(Sec. 7326, 72 Stat. 1429, as amended; 26 U.S.C. 7326)

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.
Approved September 8, 1976.

CHARLES M. WALKER,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 14, 1976, 8:45 a.m., and published in the issue of the Federal Register for September 15, 1976, 41 F.R. 39310.)

TITLE 26—INTERNAL REVENUE, CHAPTER I, SUBCHAPTER D—MISCELLANEOUS EXCISE TAXES

Republication of 1939 Code Excise Tax Regulations not Entirely Superseded

In the FEDERAL REGISTER for February 23, 1976, it was announced that the codification in Title 26 of the *Code of Federal Regulations* (Internal Revenue) of documents of general applicability and future effect as of April 1, 1976, will include, as an appendix to Subchapter D, §§ 316.1 through 316.29 of Part 316 of Treasury Regulations 46 (26 CFR (1939) Part 316). In the FEDERAL REGISTER for March 1, 1976, it was announced that this appendix will also include § 330.1-1 of Part 330 (Determination of Price and Price Readjustments), which was adopted by Treasury Decision 6340 [1959-1 C.B. 694], 23 FR 9692, December 16, 1958.

Notice is hereby given that the appendix will also contain the explanatory material set forth below.

HEADNOTE FOR 26 CFR (1939 CODE) PART 316

Sections 316.200 et seq., relating to filing requirements, etc., have been superseded. For regulations relating to administrative provisions of special application to manufacturers excise taxes, see Subpart 0 of 26 CFR Part 48 (26 CFR 48.6011(a) through 48.6675-1).

FOOTNOTES FOR 26 CFR (1939 CODE) PARTS 316 AND 330

§ 316.2—§ 316.2 sets forth the effective dates of various excise tax laws enacted before 1955. It is reproduced here for informational purposes.

§ 316.6—§ 316.6 does not apply with respect to sales after December 31, 1958. For rules applicable to sales after that date, see §§ 48.4219 and 48.4219-1.

§ 316.7—§ 316.7 does not apply with respect to sales after December 31, 1958. For rules applicable to sales after that date, see §§ 48.4218 through 48.4218-5.

§ 316.9—See section 4217(b) of the Internal Revenue Code of 1954 for a limitation on the amount of tax payable on lease payments.

§ 316.15—Paragraph (b) of § 316.15 does not apply with respect to sales at retail after December 31, 1958. For temporary rules applicable to such sales after that date, see § 148.1-5.

§§ 316.20 through 316.23— § 316.20 through 316.23 do not apply with respect to sales after December 31, 1958. For temporary rules applicable to sales after that date, see § 148.1-3.

§§ 316.24 and 316.25— 316.24 and 316.25 apply with respect to sales to purchasers who are not registered pursuant to section 4222 of the Internal Revenue Code of 1954. For temporary rules applicable to sales to purchasers who are so registered, see § 148.1-3.

§§ 316.28 and 316.29—The procedures set forth in §§ 316.28(1) through (q) and

316.29 (c) do not apply with respect to sales after December 31, 1958. For temporary rules relating to tax-free sales of supplies for vessels or aircraft to a purchaser who is registered pursuant to section 4222 of the Internal Revenue Code of 1954, see § 148.1-3. For temporary rules relating to such sales to a purchaser who is not so registered, see § 145.4-1.

§ 330.1-1—In the case of articles sold after December 31, 1960, § 330.1-1 does not apply to certain local advertising charges. For rules relating to the treatment of such charges in the case of sales after December 31, 1960, see §§ 48.4216(f) through 48.4216(f)-3.

(Filed by the Office of the Federal Register on July 7, 1976, 4:18 p.m., and published in the Federal Register for July 12, 1976, 41 F.R. 28478)

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Part II. Treaties and Tax Legislation

Subpart A.—Tax Conventions

Union of Soviet Socialist Republics

Double Taxation: Taxes on Income

Convention, with related letters, signed at Washington June 20, 1973;
Ratification advised by the Senate of the United States of America December 15, 1975;
Ratified by the President of the United States of America December 17, 1975;
Ratified by the Union of Soviet Socialist Republics December 24, 1975;
Ratifications exchanged at Moscow December 30, 1975;
Proclaimed by the President of the United States of America January 22, 1976;
Entered into force January 29, 1976;
Effective January 1, 1976.

BY THE PRESIDENT OF
THE UNITED STATES OF AMERICA

A PROCLAMATION

CONSIDERING THAT:

The Convention between the United States of America and the Union of Soviet Socialist Republics on Matters of Taxation, with related letters, was signed at Washington on June 20, 1973, the text of which Convention, with related letters, in the English and Russian languages, is hereto annexed:

The Senate of the United States of America by its resolution of December 15, 1975, two-thirds of the Senators present concurring therein, gave its advice and consent to ratification of the Convention, with related letters;

The Convention, with related letters, was ratified by the President of the United States of America on December 17, 1975, in pursuance of the advice and consent of the Senate, and was ratified on the part of the Union of Soviet Socialist Republics on December 24, 1975;

It is provided in Article XIII of the Convention that the Convention shall enter into force on the thirtieth day after the exchange of instruments of ratification, with effectiveness on January 1 of the year following the year in which the instruments of ratification are exchanged;

The instruments of ratification of the Convention were exchanged at Moscow on December 30, 1975, and accordingly the Convention, with related letters, enters into force on January 29, 1976, effective January 1, 1976;

NOW, THEREFORE, I, Gerald R. Ford, President of the United States of America, proclaim and make public the Convention, with related letters, to the end that it shall be observed and fulfilled with good faith on and after January 29, 1976, by the United States of America and by the citizens of the United States of America and all other persons subject to the jurisdiction thereof.

IN TESTIMONY WHEREOF, I have signed this proclamation and caused the Seal of the United States of America to be affixed.

DONE at the city of Washington this twenty-second day of
[SEAL] January in the year of our Lord one thousand nine hundred seventy-six and of the Independence of the United States of America the two hundredth.

GERALD R. FORD

By the President
JOSEPH JOHN SISCO
Acting Secretary of State

CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE UNION OF SOVIET SOCIALIST REPUBLICS ON MATTERS OF TAXATION

The President of the United States of America and the Presidium of the Supreme Soviet of the Union of Soviet Socialist Republics, desiring to avoid double taxation and to promote the development of economic, scientific, technical and cultural cooperation between both States, have appointed for this purpose as their respective plenipotentiaries:

The President of the United States of America:

George P. Shultz, Secretary of the Treasury of the USA; and

The Presidium of the Supreme Soviet of the Union of Soviet Socialist Republics:

Nikolai Semenovich Patolichev, Minister of Foreign Trade of the USSR;

Who have agreed as follows:

Article I

1. The taxes which are the subject of this Convention are:

(a) In the case of the Union of Soviet Socialist Republics, taxes and dues provided for by the All-Union legislation;

(b) In the case of the United States of America, taxes and dues provided for by the Internal Revenue Code.

2. This Convention shall also apply to taxes and dues substantially similar to those covered by paragraph 1. which are imposed in addition to, or in place of, existing taxes and dues after the signature of this Convention.

Article II

In this Convention, the terms listed below shall have the following meaning:

1. "Soviet Union" or "USSR" means the Union of Soviet Socialist Republics and, when used in a geographical sense, means the territories of all the Union Republics. Such term also includes:

(a) The territorial sea thereof, and

(b) The seabed and subsoil of the submarine areas adjacent to the coast thereof, but beyond the territorial sea, over which the Soviet Union exercises sovereign rights, in accordance with international law, for the purpose of exploration for and exploitation of the

[1] The official text of the convention is contained in the pamphlet of the Treaties and Other International Acts Series (TIAS) and is designated TIAS 8225. Senate Executive Report 19, page 467; Senate Executive T is not published.

natural resources of such areas. However, it is understood that such term includes such areas only to the extent that the person, property or activity with respect to which questions of taxation arise is connected with such exploration or exploitation.

2. "United States" or "USA" means the United States of America and, when used in a geographical sense, means the territories of all the states and of the District of Columbia. Such term also includes:

(a) The territorial sea thereof, and

(b) The seabed and subsoil of the submarine areas adjacent to the coast thereof, but beyond the territorial sea, over which the United States exercises sovereign rights, in accordance with international law, for the purpose of exploration for and exploitation of the natural resources of such areas. However, it is understood that such term includes such areas only to the extent that the person, property or activity with respect to which questions of taxation arise is connected with such exploration or exploitation.

3. "Resident of the Soviet Union" means:

(a) a legal entity or any other organization treated in the USSR as a legal entity for tax purposes which is created under the laws of the Soviet Union or any Union Republic and

(b) an individual resident in the Soviet Union for purposes of its tax.

4. "Resident of the United States" means:

(a) a corporation or any other organization treated in the United States as a corporation for tax purposes which is created or organized under the laws of the United States or any state thereof or of the District of Columbia and

(b) an individual resident in the United States for purposes of its tax.

5. "Contracting State" means the United States or the Soviet Union, as the context requires.

6. The term "competent authorities" means:

(a) in the case of the Soviet Union, the Ministry of Finance

(b) in the case of the United States, the Secretary of the Treasury or his delegate.

Article III

1. The following categories of income derived from sources within one Contracting State by a resident of the other Contracting State shall be subject to tax only in that other Contracting State:

(a) rentals, royalties, or other amounts paid as consideration for the use of or right to use literary, artistic, and scientific works, or for the use of copyrights of such works, as well as the rights to inventions (patents, author's certificates), industrial designs, processes or formulae, computer programs, trademarks, service marks, and other similar property or rights, or for industrial, commercial, or scientific equipment, or for knowledge, experience, or skill (know-how);

(b) gains derived from the sale or exchange of any such rights or property, whether or not the amounts realized on sale or exchange are contingent in whole or in part, on the extent and nature of use or disposition of such rights or property;

(c) gains from the sale or other disposition of property received as a result of inheritance or gift;

(d) income from the furnishing of engineering, architectural, designing, and other technical services in connection with an installation contract with a resident of the first Contracting State which are carried out in a period not exceeding 36 months at one location;

(e) income from the sale of goods or the supplying of services through a broker, general commission agent or other agent of independent status, where such broker, general commission agent or other agent is acting in the ordinary course of his business;

(f) reinsurance premiums; and

(g) interest on credits, loans and other forms of indebtedness connected with the financing of trade between the USA and the USSR except where received by a resident of the other Contracting State from the conduct of a general banking business in the first Contracting State.

2. A Contracting State shall not attribute taxable income to the following activities conducted within that Contracting State by a resident of the other Contracting State:

(a) the purchase of goods or merchandise;

(b) the use of facilities for the purpose of storage or delivery of goods or merchandise belonging to the resident of the other Contracting State;

(c) the display of goods or merchandise belonging to the resident of the other Contracting State, and also the sale of such items on termination of their display;

(d) advertising by a resident of the other Contracting State, the collection or dissemination of information, or the conducting of scientific research, or similar activities, which have a preparatory or auxiliary character for the resident.

Article IV

1. Income from commercial activity derived in one Contracting State by a resident of the other Contracting State, shall be taxable in the first Contracting State only if it is derived by a representation.

2. The term "representation" means:

(a) with regard to income derived within the USSR, an office or representative bureau established in the USSR by a resident of the United States in accordance with the laws and regulations in force in the Soviet Union;

(b) with regard to income derived within the USA, an office or other place of business established in the USA by a resident of the Soviet Union in accordance with the laws and regulations in force in the United States.

3. In the determination of the profits of a representation, there shall be allowed as deductions from total income the expenses that are connected with the performance of its activity, including executive and general administrative expenses.

4. This article applies to income, other than income of an individual dealt with in Article VI, from the

furnishing of tour performances and other public appearances.

5. The provisions of this article shall not affect the exemptions from taxes provided for by Articles III and V.

Article V

1. Income which a resident of the Soviet Union derives from the operation in international traffic of ships or aircraft registered in the USSR and gains which a resident of the USSR derives from the sale, exchange, or other disposition of ships or aircraft operated in international traffic by such resident and registered in the USSR shall be exempt from tax in the United States.

2. Income which a resident of the United States derives from operation in international traffic of ships or aircraft registered in the USA and gains which a resident of the USA derives from the sale, exchange, or other disposition of ships or aircraft operated in international traffic by such resident and registered in the USA shall be exempt from tax in the Soviet Union.

3. Remuneration derived by an individual from the performance of labor or personal services as an employee aboard ships or aircraft operated by one of the Contracting States or a resident thereof in international traffic shall be exempt from tax in the other Contracting State if such individual is a member of the regular complement of the ship or aircraft.

Article VI

1. *Special exemptions.*

Income derived by an individual who is a resident of one of the Contracting States shall be exempt from tax in the other Contracting State as provided in subparagraphs (a) through (f).

(a) *Governmental employees.*

(1) An individual receiving remuneration from government funds of the Contracting State of which the individual is a citizen for labor or personal services performed as an employee of governmental agencies or institutions of that Contracting State in the discharge of governmental functions shall not be subject to tax on such remuneration in that other Contracting State.

(2) Labor or personal services performed by a citizen of one of the Contracting States shall be treated by the other Contracting State as performed in the discharge of governmental functions if such labor or personal services would be treated under the internal laws of the first Contracting State as so performed. However, it is understood that persons engaged in commercial activity, such as employees or representatives of commercial organizations of the USA and employees or representatives of the foreign trade organizations of the USSR, shall not be considered in the USSR and USA respectively as engaged in the discharge of governmental functions.

(3) The provisions of this Convention shall not affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under special agreements.

(b) *Participants in programs of intergovernmental cooperation.*

An individual who is a resident of one of the Contracting States and who is temporarily present in the other Contracting State under an exchange program provided for by agreements between the governments of the Contracting States on cooperation in various fields of science and technology shall not be subject to tax in that other Contracting State on remuneration received from sources within either Contracting State.

(c) *Teachers and researchers.*

(1) An individual who is a resident of one of the Contracting States and who is temporarily present in the other Contracting State at the invitation of a governmental agency or institution or an educational or scientific research institution in that other Contracting State for the primary purpose of teaching, engaging in research, or participating in scientific, technical or professional conferences shall not be subject to tax in that other Contracting State on his income from teaching or research or participating in such conferences.

(2) Subparagraph (1) shall not apply to income from research if such research is undertaken primarily for the benefit of a private person or commercial enterprise of the USA or a foreign trade organization of the USSR. However, subparagraph (1) shall apply in all cases where research is conducted on the basis of intergovernmental agreements on cooperation.

(d) *Students.*

An individual who is a resident of one of the Contracting States and who is temporarily present in the other Contracting State for the primary purpose of studying at an educational or scientific research institution or for the purpose of acquiring a profession or a specialty shall be exempt from taxes in the other Contracting State on a stipend, scholarship, or other substitute type of allowance, necessary to provide for ordinary living expenses.

(e) *Trainees and specialists.*

An individual who is a resident of one of the Contracting States, who is temporarily present in the other Contracting State for the primary purpose of acquiring technical, professional, or commercial experience or performing technical services, and who is an employee of, or under contract with, a resident of the first mentioned Contracting State, shall not be subject to tax in that other Contracting State on remuneration received from abroad. Also, such individual shall not be subject to tax in that other Contracting State on amounts received from sources within that other Contracting State which are necessary to provide for ordinary living expenses.

(f) *Duration of exemptions.*

The exemptions provided for under subparagraphs (b), (c), (d), and (e) of this article shall extend only for such period of time as is required to effectuate the purpose of the visit, but in no case shall such period of time exceed:

(1) One year in the case of subparagraphs (b) (Participants in programs of intergovernmental cooperation) and (e) (Trainees and specialists);

(2) Two years in the case of sub-

paragraph (c) (Teachers and researchers); and

(3) Five years in the case of subparagraph (d) (Students). If an individual qualifies for exemption under more than one of subparagraphs (b), (c), (d), and (e), the provisions of that subparagraph which is most favorable to him shall apply. However, in no case shall an individual have the cumulative benefits of subparagraphs (b), (c), (d), and (e) for more than five taxable years from the date of his arrival in the other Contracting State.

2. *General exemptions.*

Income derived by an individual who is a resident of one of the Contracting States from the performance of personal services in the other Contracting State, which is not exempt from tax in accordance with paragraph 1. of this article, may be taxed in that other Contracting State, but only if the individual is present in that other Contracting State for a period aggregating more than 183 days in the taxable year.

Article VII

This Convention shall not restrict the right of a Contracting State to tax a citizen of that Contracting State.

Article VIII

This Convention shall apply only to the taxation of income from activity conducted in a Contracting State in accordance with the laws and regulations in force in such Contracting State.

Article IX

If the income of a resident of one of the Contracting States is exempt from tax in the other Contracting State, in accordance with this Convention, such resident shall also be exempt from any tax which is at present imposed or which may be imposed subsequently in that Contracting State on the transaction giving rise to such income.

Article X

1. A citizen of one of the Contracting States who is a resident of the other Contracting State shall not be subjected in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof carrying on the same activities.

2. A citizen of one of the Contracting States who is a resident of the other Contracting State or a representation established by a resident of the first Contracting State in the other Contracting State shall not be subjected in that other Contracting State to more burdensome taxes than are generally imposed in that State on citizens or representations of residents of third States carrying on the same activities. However, this provision shall not require a Contracting State to grant to citizens or representations of residents of the other Contracting State tax benefits granted by special agreements to citizens or representations of a third State.

3. The provisions of paragraphs 1. and 2. of this article shall apply to taxes of any kind imposed on the Federal or All-Union level, the state or Republic level, and on the local level.

Article XI

1. If a resident of one of the Contracting States considers that the action of one or both of the Contracting States results or will result for him in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by the laws of the Contracting States, present his case to the competent authorities of the Contracting State of which he is a resident or citizen. Should the claim be considered to have merit by the competent authorities of the Contracting State to which the claim is made, they shall endeavor to come to an agreement with the competent authorities of the other Contracting State with a view to the avoidance of taxation not in accordance with the provisions of this Convention.

2. In the event that such an agreement is reached the competent authorities of the Contracting States shall, as necessary, refund the excess amounts paid, allow tax exemptions, or levy taxes.

Article XII

The competent authorities of the Contracting States shall notify each other annually of amendments of the tax legislation referred to in paragraph 1. of Article I and of the adoption of taxes referred to in paragraph 2. of Article I by transmitting the texts of amendments or new statutes and notify each other of any material concerning the application of this Convention.

Article XIII

This Convention shall be subject to ratification and shall enter into force on the thirtieth day after the exchange of instruments of ratification. [1] The instruments of ratification shall be exchanged at Moscow as soon as possible.

The provisions of this Convention shall, however, have effect for income derived on or after January 1 of the year following the year in which the instruments of ratification are exchanged.

Article XIV

1. This Convention shall remain in force for a period of three years after it takes effect and shall remain in force thereafter for an indefinite period. Either of the Contracting States may terminate this Convention at any time after three years from the date on which the Convention enters into force by giving notice of termination through diplomatic channels at least six months before the end of any calendar year. In such event, the Convention shall cease to have effect beginning on January 1 of the year following the year in which notice is given.

2. Notwithstanding the provisions of paragraph 1. of this article, upon prior notice to be given through diplomatic channels, the provisions of subparagraphs (e), (f), or (g) of paragraph 1. of Article III and the provisions of Article IX may be terminated separately by either Contracting State at any time after three years from the date on which this Convention enters into force. In such event such provisions shall cease to have effect beginning on

[1] Jan. 29, 1976.

January 1 of the year following the year in which notice is given.

In witness whereof, the plenipotentiaries of the two Contracting States have signed the present Convention and have affixed their seals thereto.

Done at Washington, this 20th day of June, 1973, in duplicate, in the English and Russian languages, both texts being equally authentic.

For the President
of the United States
of America
GEORGE P. SHULTZ

For the Presidium of the
Supreme Soviet of the Union
of Soviet Socialist Republics
N. PATOLICHEV

[RELATED LETTERS]

THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

JUNE 20, 1973

DEAR MR. MINISTER:

In connection with the Income Tax Convention signed today, I should like to state our understanding of the agreement reached by the delegations of the United States of America and of the Union of Soviet Socialist Republics concerning the application of certain provisions of the Convention.

1. In connection with Article III, subparagraph 1.(e), it is our understanding that Soviet foreign trading organizations perform the functions of a broker or general commission agent for various Soviet industrial and other organizations in the purchase of goods and services from foreign suppliers. Accordingly, a representation of a United States commercial organization in the Soviet Union making sales to a Soviet foreign trading organization will be regarded as making sales through a broker or general commission agent.

It is understood that a firm acting in the USA as a broker, general commission agent or other agent for a Soviet foreign trade organization will not be considered to be of independent status if it is owned or otherwise controlled by an authorized organization of the Soviet Union.

It is also understood that if such a broker, general commission agent or other agent has no income other than commission income, such broker, general commission agent or other agent will be taxable only on such commission income.

2. In Article VI, subparagraphs 1. (d) and (e) provide exemption under certain circumstances of an amount "necessary to provide for ordinary living expenses." It is agreed that the exemption under subparagraph 1.(e) in any taxable year will not apply to any amount in excess of $10,000 or its equivalent in rubles, and that the exemption under subparagraph 1.(d) will generally apply to a lesser amount, to be determined in each specific case.

3. With respect to income mentioned in Article V, it is understood that each of the Contracting States will, if necessary, endeavor to secure exemption from taxes which may be imposed in Republics, states, or at the local level.

4. It is understood that both Contracting States continue to exercise tax jurisdiction over journalists and press, television, and radio correspondents on foreign assignment. Accordingly, it is agreed on the basis of reciprocity that subparagraph 1.(c) (1) of Article VI shall apply to such journalists and correspondents for a two-year period whether or not they are present in the other Contracting State at the invitation of a governmental agency or institution. It is understood that the exemption granted by the host country will apply only to compensation received from abroad.

5. It is understood that customs duties are not considered taxes for purposes of Article IX and paragraph 3 of Article X.

Please accept, Mr. Minister, assurances of my highest consideration.

Sincerely yours,
GEORGE P. SHULTZ

Mr. NIKOLAI S. PATOLICHEV
Ministry of Foreign Trade
Union of Soviet Socialist
Republics

Senate Executive Report No. 19
1st Session

[Bracketed numerals indicate official report page numbers.]

TAX CONVENTION WITH U.S.S.R.

DECEMBER 11, 1975

Mr. SPARKMAN, from the Committee on Foreign Relations, submitted the following report to accompany Ex. T, 93-1.

The Committee on Foreign Relations, to which was referred the Convention between the United States of America and the Union of Soviet Socialist Republics on Matters of Taxation,[1] with related letters, signed at Washington on June 20, 1973, having considered the same, reports favorably thereon without reservation and recommends that the Senate give its advice and consent to ratification thereof.

SUMMARY OF MAJOR PROVISIONS

At the request of the Committee on Foreign Relations, the staff of the Joint Committee on Internal Revenue Taxation prepared an explanation and analysis of the convention with the Soviet Union. Set forth below is a summary of the more important features of the convention which was submitted by the Joint Committee staff:

There is presently no income tax convention between the United States and the Union of Soviet Socialist Republics (U.S.S.R.). Adoption of the proposed U.S.S.R. income tax convention is desirable for a number of reasons. Over the years, there has been limited contact between the United States and the U.S.S.R. with the result that the citizens and businesses of each country have had little contact

[1] Page 463; Senate Executive T is not published.

with the tax system of the other country. However, it appears that there will be an increasing amount of economic and cultural contact between the two countries which could generate an increasing number of tax problems.

Recently there has been a trend toward modernization and standardization in international tax relationships. The model income tax convention of the Organization for Economic Cooperation and Development (OECD) and the recent revision of many U.S. income tax treaties (for example, the Japanese and Norwegian Conventions) are examples of this trend. [2] However, the proposed U.S.-U.S.S.R. Income Tax Convention does not conform to this pattern and does not deal with many of the matters which are normally covered in United States income tax conventions. It is probable that this difference is attributable to the contrasting political and economic systems of the two countries. U.S.S.R. nationals are not permitted to hold investments in foreign countries and foreign entities are required to deal through State trading companies. Moreover, business with a State trading economy is done on a significantly different basis than with a free market economy. Additionally, the U.S.S.R. has had relatively little experience in dealing with market economy countries and their tax laws, in contrast to some of the other non-market economy countries which have in the not too distant past had experience with free market economies.

As a result, the Soviet tax structure is less developed in respect to foreign entities and persons than is the tax structure of other non-market countries. Therefore, many of the articles which are contained in the more recently negotiated income tax conventions between the United States and other countries have been either substantially modified or excluded from the proposed treaty.

Because of this lack of experience in dealing with types of economies of the other country, either the U.S.S.R. or the United States may terminate the proposed convention at any time after 3 years from its entry into force (rather than 5 years as is provided in the usual treaty). Otherwise the treaty will remain in force indefinitely. This rather short three-year period of time will give the two countries an opportunity to adjust the rules contained in the proposed convention as their experience dictates, after the initial 3-year period ends.

One of the more significant features of the proposed convention is that income which a resident of one country derives from commercial activities in the country will be exempt from tax in the source country unless it is attributable to an office or other place of business that the resident has in the source country. This feature of the proposed convention is similar to provisions contained in other U.S. tax conventions to the effect that industrial or commercial profits derived in a source country are exempt from tax unless the resident has a permanent establishment in the source country with which the income is effectively connected.

The proposed convention also provides that certain types of income are to be exempt from taxation in the source country even where the income is attributable to an office, or a representation, in the source country.

These exempt items of income are (a) rentals or royalties for the use of patents, copyrights, equipment and know-know; (b) payments for engineering, architectural and other technical services; (c) interest on indebtedness in connection with the financing of trade between the two countries; (d) reinsurance premiums; and (e) income from the sale of goods [3] or services through a commission agent of independent status. While the method of dealing with these items is different from that found in other U.S. tax treaties, the results obtained are consistent with those found in the other treaties.

The other more important features of the proposed convention are the following:

(1) The United States and the Soviet Union are defined to include their respective continental shelves insofar as income arising from the exploration and exploitation of natural resources on the continental shelf is concerned. The effect of this provision is to recognize a country's jurisdiction to tax income arising in connection with natural resource activities on that country's continental shelf.

(2) A reciprocal exemption is provided for income and gains from shipping and air transportation.

(3) A reciprocal exemption is provided on income from personal services if the individual is present in the host country for 183 days or less and will be exempt for longer periods if the individual falls into a specified category such as a teacher or student.

(4) A specific prohibition is provided against one of the countries subjecting a citizen of the other country who is residing in the host country to more burdensome taxes than a citizen and a resident of the host country. Also a business or office established by a resident of one country in the other country is not to be subjected in that other country to more burdensome taxes than are generally imposed in that other country on businesses or offices of residents of third countries carrying on the same activities.

The Committee on Foreign Relations held a public hearing on the Tax Convention with the Soviet Union on November 7, 1975. At that time Mr. Charles M. Walker, Assistant Secretary of the Treasury for Tax Policy, testified in support of the convention. Pertinent portions of his prepared statement, as well as a technical memorandum on the convention, are reprinted in the appendix to this report. Mr. Howard Silverstone, International Tax Counsel, testified on behalf of the staff of the Joint Committee on Internal Revenue Taxation. In addition, he submitted an explanation and analysis of the Soviet convention which is also incorporated in the appendix.

During the course of the Committee's hearing, it was pointed out that Article VIII of the Soviet convention contains language which does not ar-

pear in any other tax treaty to which the United States is a party. Article VIII provides that the convention "shall apply only to the taxation of income from activity conducted in a Contracting State in accordance with the laws and regulations in force in such Contracting State." Since the Committee was concerned about the interpretation and application of this provision, the Treasury and State Departments were asked for clarification. Letters from both Departments appear in the appendix to this report.

In the Committee's opinion, as a matter of tax policy, this type of provision should not be included in tax treaties. Nevertheless, in view [4] of the Treasury Department's assurances that the provision will be narrowly construed, and the State Department's belief that favorable action would have a positive effect on United States-Soviet bilateral relations, the Committee decided to recommend approval of the treaty. The Committee wishes to emphasize, however, that it does not regard the provision as a precedent for future treaties and urges the Executive Branch to make every effort to bring about its removal at the appropriate time.

On December 9, 1975, by a voice vote, the Committee ordered the Tax Convention with the Soviet Union reported favorably to the Senate for advice and consent to ratification.

[5] APPENDIX

Statement of the Honorable Charles M. Walker, Assistant Secretary of the Treasury for Tax Policy

General Income Tax Treaty Objectives

A basic objective of our income tax conventions, as their full titles imply, is to prevent double taxation of income. But fundamentally, our treaties are also intended to facilitate trade and investment between the United States and our treaty partners. Our tax treaties play an important role in this respect by providing greater certainty as to the rules of taxation for foreign business and investment and by clarifying the inter-action of U.S. and foreign laws; they eliminate, where appropriate, the need to file tax returns and to become conversant with the details of the tax laws of more than one country; they provide a mechanism for bilateral cooperation by the tax authorities with respect to the resolution of tax conflicts; they contain provisions facilitating the exchange of scholars, engineers, technicians and others; and they seek to achieve tax neutrality with respect to the flow of capital. The treaties thereby complement other efforts by the U.S. to promote free trade and capital movements. At the same time, they provide a bilateral mechanism for cooperation between government tax authorities in the administration of their laws.

Our tax treaties basically follow the model prepared by the Fiscal Committee of the Organization for Economic Cooperation and Development. This model has served as the basis for hundreds of bilateral conventions between the OECD member countries. The United States today has more than 30 treaties in force and a dozen or more in various stages of negotiation.

Our income tax conventions avoid double taxation by establishing rules for dividing or assigning taxing jurisdiction between the country of the taxpayer's residence and the country where the income arises (the country of source). Where there is only a temporary or minimal presence in the source country, the conventions typically provide for taxation exclusively by the residence country. Thus, ordinarily businesss income is not taxable in the source country unless the taxpayer has a fixed place of business there, and employees temporarily in the source state are not taxable on their wages in that state unless they are there for a substantial period of time. Withholding taxes at the source on passive income in the form of dividends, interest and royalties are usually reduced or eliminated under the treaties.

Where a convention permits both countries to tax income, it typically requires the residence country to grant a foreign tax credit for the source country tax. In addition, the source country tax on dividends, interest and royalties, where not eliminated by the convention, is gen- [6] erally subject to a maximum rate which is intended to ensure that the tax may be fully credited against the residence country tax.

Our income tax conventions are not designed to alter the U.S. tax liability of U.S. residents, corporations or citizens. U.S. taxpayers continue to be taxed according to our law. The conventions are designed to obtain tax benefits for U.S. corporations and residents from our treaty partners in exchange for similar benefits which we grant to their taxpayers.

The conventions also typically guarantee that taxpayers from one country will not be subject to discriminatory taxes in the other country. And they provide for administrative cooperation in avoiding double taxation and in preventing fiscal evasion.

The Convention with the Soviet Union

Unlike the tax systems of Romania and Poland, that of the Soviet Union bears little resemblance to the methods of taxing business income common in western countries. The convention with the U.S.S.R. is the first comprehensive income tax convention signed by the U.S.S.R., and we have had to deal for the first time with the interaction of two widely differing economic systems. The solutions arrived at are perhaps less unusual than might be expected, but do involve a broader scope of exemptions than our traditional income tax conventions.

Most business activity in the Soviet Union is conducted through state enterprises whose profits, after allocations to certain enterprise funds (e.g., for employee benefits and bonuses), are transferred to the State budget. This amounts to virtually a 100 percent tax. Moreover, Soviet accounting concepts are so different from those common to western econ-

omies that the tax is not related to net income as we know it.

With respect to Soviet business activities in the United States there is a practical problem of determining the taxable income in the United States of a branch of a Soviet enterprise; it would be extremely difficult to determine arm's length prices between two units of a government enterprise, and to obtain the necessary access to the financial accounts of the enterprise. With respect to U.S. business activities in the U.S.S.R., the issue is to minimize the prospective tax burden. The U.S.S.R. does not now impose income tax on foreign companies carrying on business activities there, but is studying other tax systems with a view to introducing such a tax. Therefore, in seeking to achieve reciprocity overall it was considered appropriate to expand somewhat the scope of exemptions usually granted under the permanent establishment concept in order to preserve the exemptions now granted to U.S. firms by the U.S.S.R.

The convention provides for reciprocal exemption at source of interest and royalties. There is now no U.S.S.R. tax on interest or patent royalties paid to nonresidents. However, since signature of the convention, the U.S.S.R. has introduced a withholding tax on copyright royalties at a rate equal to the foreign rate on such payments to residents of the U.S.S.R., from which U.S. residents will be exempt from the tax under the convention. There is no provision in the convention regarding taxes on dividends, since there are no dividends paid by enterprises in the U.S.S.R.

In the case of personal service income, the convention also provides more situations than usual in which temporary visitors will be exempt [7] from tax by the host country. In addition to the usual provisions, the convention provides a 12 month exemption for persons supplying technical services and a two year exemption for correspondents. The exemption for technicians will be helpful to U.S. employees sent to the U.S.S.R. to install equipment purchased from the United States; there are numerous U.S. employees in this situation in connection with the vast Kama River truck foundry.

The two year exemption for correspondents is unique to this convention and was inserted because it was a matter of great importance to the Soviet Union. The Soviet Union in general taxes its citizens employed abroad without a foreign tax credit, and seeks to avoid double taxation by obtaining exemption in the host country on a reciprocal basis. In the case of correspondents, most other countries have agreed administratively with the Soviet Union to grant reciprocal exemption. We agreed to a limited (two year) exemption under the convention; it was placed in the letters accompanying the convention rather than in the body of the convention itself because, although the letters are equally subject to approval for ratification, they are less likely to be viewed by other countries as a precedent for future U.S. treaties.

Like the conventions with Romania and Poland, this convention also assures that the nondiscrimination rules, as applied to U.S. firms, will be determined not by reference to the heavily taxed state enterprises but by reference to the taxes imposed on firms of other countries doing business in the Soviet Union.

The administrative provisions in the convention are more limited than usual, due largely to the limited scope of Soviet taxes and business relations. However, the convention does provide for administrative cooperation to resolve difficulties and avoid double taxation. The United States foreign tax credit for U.S.S.R. taxes paid by U.S. residents is available to U.S. residents under the conditions set forth in the Internal Revenue Code, although it is not so specified in the convention; as mentioned above the U.S.S.R. does not give a foreign tax credit to its residents.

The convention contains two additional provisions not found elsewhere which were added for clarification. It provides that where income is exempt from tax under the convention the underlying transaction will also be exempt from tax, to provide protection against turnover and other taxes. The Soviet delegation felt it important to state explicitly that transactions giving rise to treaty benefits must be within the laws of the country granting the treaty benefit.

I have been concentrating on the differences between this convention and other recent U.S. income tax conventions. However, our goal in negotiating the convention with the Soviet Union was the same as that of all our income tax conventions: to facilitate our economic and cultural relations by removing tax obstacles to the flow of people, technology, and capital between the two countries. We have tried to take account of special factors, as we do in each negotiation, but always within the boundaries of sound income tax policy.

[8] MEMORANDUM PREPARED FOR THE USE OF THE COMMITTEE ON FOREIGN RELATIONS BY THE STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

GENERAL EXPLANATION

Article I. Taxes covered

The proposed convention applies to the U.S. Federal income tax. It is intended that the proposed convention not apply to any U.S. taxes which are in the nature of a penalty (such as the accumulated earnings tax and the personal holding company tax). In the case of the U.S.S.R., the proposed convention applies to all taxes and dues imposed by legislation at the national level. Among the taxes and dues imposed by the U.S.S.R. at the national level are a personal income tax, a transfer of a portion of the profits of State enterprises to the State, and a turnover tax. State and local taxes of the United States and Republic taxes, duties, and dues imposed by the Union Republics of the U.S.S.R. generally are not included in the proposed convention.

The proposed convention also con-

tains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes which either county may subsequently impose. Since the Soviet Union is presently studying how other nations tax nonresidents this provision is of significant importance.

Additionally, it is provided that the exemption from taxation for income from specific types of transactions is to apply to all transaction taxes imposed by the Internal Revenue Code and all national taxes imposed by the Soviet Union (Article IX). The mutual agreement provisions (Article XI) and the exchange of information provisions (Article XII) also apply to all national taxes. The nondiscrimination provisions apply to taxes of every kind imposed at the national, Republic or State, or local level.

Article II. General Definitions

The standard definitions found in most of our income tax treaties are contained in the proposed convention. However, unlike more recent conventions, no procedure for establishing the meaning of undefined terms is provided.

In addition, the proposed convention contains a provision which is contained in the more recent U.S. treaties which includes within the definition of the term "United States" the territorial sea of the United States and the continental shelf of the United States insofar as the exploration and exploitation of natural resources on the continental shelf are concerned. This expanded definition, however, is applicable for purposes of the proposed convention only to the extent that the person, property, or activity of concern is connected with the exploration and exploitation of natural resources. A similar definition of the U.S.S.R. is contained in the proposed convention. The definition of continental shelf areas contained in the proposed convention is similar [9] to that contained in the recent conventions with Trinidad and Tobago, Belgium, and Norway and to that provided in the Internal Revenue Code, except that under the Code the continental shelf definition applies only with respect to mines, oil and gas wells, and other natural deposits. In practical operation, however, the convention provision will be similarly restricted to the provision of the Code. The activity of fishing is not intended to be considered the exploration or exploitation of natural resources of the continental shelf, and as a result the definition of continental shelf is not to apply with respect to this activity.

Article III. Exempt Items of Income

Under the proposed convention, certain types of income (set out below) derived by a resident of one country are exempt from taxation by the other country. Moreover, the exemption applies even though the resident has a representation (permanent establishment) in the country in which the income is derived and the rights or property giving rise to the income is effectively connected with that representation. Generally, under the U.S. tax treaties the country of source has the right to tax income attributable to a permanent establishment located within its borders. As a result the proposed exemption is broader than under other U.S. income tax treaties.

The proposed convention provides an exemption for rentals, royalties, and other amounts paid as consideration for the use of, or the right to use, literary, artistic, and scientific works, amounts paid for the use of copyrights of these works, patents, industrial designs, processes or formulae, computer programs, trademarks, service marks, or other similar property or rights for industrial, commercial, or scientific equipment, or for knowledge, experience, or skill (know-how). Gains derived from the sale or exchange of these rights or property are also exempt whether or not the amounts realized on the sale or exchange are contingent (in whole or in part) on the extent and nature of the use or disposition of these rights or property. While the exemption in the proposed convention is broader than in other treaties in that the attribution of the payments to a permanent establishment does not terminate the exemption, it is not expected to be broader in practice, since these types of payments are not usually attributable to a permanent establishment.

The proposed convention also provides that gains from the sale (or other disposition) of real or personal property received as an inheritance or gift is exempt from taxation by the country of source if derived by a resident of the other country. This provision does not affect the estate tax, but only the gain on the disposition of the property by the heir. In most cases this provision will have little significance since generally no capital gains tax is imposed on a nonresident alien unless present in the United States for more than 183 days during the taxable year. This exemption could have some limited impact, however, in those cases where the inherited property is being used in a trade or business in the United States. When property is so used, the 183-day exemption does not apply under the tax law and absent the treaty provision a tax otherwise would be imposed under the Code.

It is doubtful, however, whether this provision will have any practical significance since it is illegal for Soviet residents to own property outside of the Soviet Union. Any property which a Soviet resi [10] dent might inherit in the United States would have to be disposed of immediately.

The proposed convention also exempts from tax in the source country income from the furnishing of engineering, architectural, designing, and other technical services in connection with an installation contract with a resident of that country. However, for this rule to apply, the services must be performed within a period not exceeding 36 months in one location. For example, if a U.S. resident derives income from sources within the Soviet Union, the United States has exclusive taxing jurisdiction under the proposed convention if the income was derived from the furnishing of engineering services in connection with a contract with a Soviet resident but only if the services were carried out in a period

not exceeding 36 months at one location. Similar results are achieved under the permanent establishment articles of other U.S. income tax conventions. The definition of resident in Article II of the proposed convention indicates that this exemption is not applicable for services performed for a governmental agency but is applicable to state trading companies.

The proposed convention also provides that income derived from sources within one country by a resident of the other country from the sale of goods or the supplying of services through a broker, general commission agent, or other agent of independent status, acting in the ordinary course of his business, is exempt from tax in the country of source. This provision does not exempt the broker but rather the entity making use of the broker.

It is important to understand the operation of Soviet foreign trading activities in order to understand this provision. In the Soviet Union, foreign trade is the responsibility of governmentally controlled State foreign trading organizations, which are generally operated by and subordinate to the Ministry of Foreign Trade. These State foreign trading organizations are organized along commodity lines. They are authorized to purchase and sell commodities, patents, and technology within their specified commodity areas. A few of these State foreign trading organizations are authorized to trade within particular geographic regions, and a few organizations are charged with providing such auxiliary functions as insurance, freight forwarding, advertising, and tourism.

In an exchange of letters between the Soviet Union and the United States, it is clarified that Soviet foreign trading organizations perform the functions of an independent broker or general commission agent for various Soviet industrial and other organizations in the purchase of goods and services from foreign suppliers. Therefore, a representation of a U.S. commercial organization in the Soviet Union which makes sales to a State foreign trading organization is to be regarded as making sales through a broker or general commission agent, and the income of the representation from these sales will be exempt from tax by the Soviet Union.

The exchange of letters also provides that, with respect to the Soviet Union, a firm acting in the United States as a broker, general commission agent, or other agent, for a State foreign trading organization will not be considered to be of independent status if it is owned or otherwise controlled by an authorized organization of the Soviet Union. This understanding has the effect of providing that a Soviet [11] foreign trading organization is not exempt from U.S. tax if the organization's representation in the United States sells through a "second" State foreign trading organization also having a representation in the United States since the second State foreign trading organization is not treated as having an independent status by reason of being owned or controlled by the first organization. Under these rules the first organization is subject to U.S. tax on its commission income.

However, if a Soviet foreign trading organization sells in the United States through an independent broker the trading organization is not subject to tax on its profits. The broker must be more than a mere accommodation party and must be the party which makes the sales in the ordinary course of its trade or business. This provision is not satisfied if, for example, the trading organization actively solicits customers and then has the sale made through the broker.

Exempting the income of a representation of a nonresident from taxation in the country of source is contrary to the other U.S. income tax conventions, which provide that income attributable to a permanent establishment located in the source country is taxable in that country. However, since in many cases U.S. firms are able to sell goods without establishing a permanent establishment in the source country, this difference should not be very significant, particularly since U.S. permanent establishments in the U.S.S.R. are likely to be limited.

The proposed convention also provides that income from premiums for the reinsurance of property or risks derived from sources within one of the countries is exempt from tax in that country. Any income derived from insurance premiums, however, is not exempt under this provision.

The proposed convention provides that interest on credits, loans, and other forms of indebtedness connected with the financing of trade between the United States and the Soviet Union is exempt from tax in the country of source. No definition is provided of what is intended by the word "trade." Presumably, it includes the sale of goods, services, and technology. Under this rule, a representation in the Soviet Union of a U.S. resident is exempt from taxation by the Soviet Union on interest received on loans used to finance sales to the Soviet Union. An exception to this rule is specifically provided so that interest received by a resident of one country from the conduct of a banking business in the source country is not exempt in the source country.

The proposed convention also provides that income is not to be attributed by a country to certain activities conducted within that country by a resident of the other country. Thus, a country is not to attribute income to the purchase of goods or merchandise within that country by a resident of the other country. Similar rules also apply to the following activities: the use of the facilities for the purpose of storage or delivery of goods or merchandise belonging to the resident of the other country; the display of goods or merchandise belonging to the resident of the other country, and also the sale of these items on termination of their display if they are not carried on the resident's inventory; and advertising by a resident of the other country, the collection or dissemination of information, or the conducting of scientific research, or similar activities, which have a preparatory or auxiliary character for the resident.

[12] This provision of the proposed convention generally reaches the same result as other U.S. income tax conventions. That is, these activities generally appear as activities which will not create a permanent establishment. Further, other U.S. tax conventions provide that profits will not be attributed to a permanent establishment in the case of its purchase of goods or merchandise.

Article IV. Representation

Under the proposed convention, income derived from commercial activities in one country by a resident of the other country is taxable in the source country only to the extent it is attributable to a representation which the resident has in the source country. This concept, usually referred to as a permanent establishment in other U.S. income tax conventions, is one of the basic devices used in income tax treaties to avoid double taxation. The term "representation" was used to accommodate the Soviet Union.

The term "representation" means an office, representative bureau, or other place of business established in one of the countries by a resident of the other country in accordance with the laws and regulations governing the formation and licensing of businesses (including Republic or State, or local laws) in force in the source country. This definition is not as complete a definition of permanent establishment as appears in the OECD model convention and other U.S. income tax treaties.

In computing the taxable business profits, the proposed convention allows the deduction of all expenses, wherever incurred, which are reasonably connected with the business profits.

Article V. Shipping and air transport

The proposed convention provides for a reciprocal exemption of profits from ships or aircraft operated in international traffic. Under the provision, the country of source is to exempt the income of a resident of the other country derived from the operation in international traffic of ships or aircraft which are registered in the country of the resident. The exemption also applies to gains from the sale or exchange of a ship or aircraft the income from the operation of which was exempt under the treaty. In addition, the proposed convention provides that remuneration derived by an individual from the performance of labor or personal services as an employee aboard a ship or aircraft operated by one of the countries or a resident of that country in international traffic is to be exempt from tax in the country of source if the individual is a member of the regular complement of the ship or aircraft. The provisions of this article of the proposed convention are similar to those found in most U.S. tax conventions. In an exchange of letters accompanying the proposed convention it is agreed that each country will use its best offices to secure exemption from income taxation at the Republic or State or local levels which may be imposed on the operations of ships or aircraft. The United States has expressed a willingness to undertake this commitment in connection with a number of other recently ratified tax conventions.

Article VI. Exemptions for individuals

The proposed convention provides for a series of exemptions for income earned by an individual who is a resident of one country from personal services performed in the other country.

[13] The first exemption provides that a citizen of one country receiving remuneration from that country for labor or personal services performed as an employee of a governmental agency or institution of that country "in the discharge of governmental functions" is exempt from tax by the other country. Individuals who are employed in commercial activities are not considered to be engaged in the discharge of governmental functions. The exemption does not extend to Republic or State or local governmental employees. This exemption is similar to exemptions provided in other U.S. tax conventions except that some of these conventions exempt local governmental employees.

The proposed convention provides that the definition of governmental functions is defined under the internal laws of the country paying for the services. However, persons engaged in commercial activity such as employees or representatives of commercial organizations and employees of the foreign trade organizations of the U.S.S.R. are not considered as engaged in the discharge of governmental functions.

Second, the proposed convention provides that a resident of one country who is temporarily present in the other country under an exchange program provided for by agreement between the two countries in various fields of science and technology is exempt from tax in the source country on remuneration received from sources within either country. In no case does the period of exemption under this provision extend for more than one year. This provision is similar to provisions found in other U.S. tax conventions, except that there generally is a dollar limitation.

Third, a resident of one country who is temporarily present in the other country, at the invitation of a governmental agency or an educational or scientific research institution in that other country for the primary purpose of teaching, engaging in research or participating in scientific technical or professional conferences, is exempt from tax in the source country on his income from teaching, research, or participation in the conference. This exemption does not apply to research undertaken primarily for the benefit of a private person or commercial enterprise in the United States or a foreign trade organization of the U.S.S.R. However, the exemption does apply in all cases where the research is conducted on the basis of intergovernmental agreements of cooperation. In no case, however, does the period of exemption extend for more than two years.

In an exchange of notes accompanying the proposed convention, the two

countries agreed that the exemption accorded teachers and researchers is to be extended to journalists and correspondents on compensation received from abroad for periods not exceeding two years. A special exemption for reporters and correspondents is not found in any other U.S. tax treaty. It is understood that this exemption was agreed to because U.S. correspondents apparently are the only foreign correspondents subject to tax in the Soviet Union. However, the Soviet Union has indicated it will only grant this exemption on a reciprocal basis.

Although the United States has tax conventions with a number of countries providing for exemptions for researchers and teachers, in none of these conventions has that exemption been construed to include journalists and correspondents. While it may well be appropriate to extend on a reciprocal basis a limited exemption to correspondents and [14] journalists, it is difficult to see the basis in the treaty language for this exemption. Providing of an exemption through an exchange of notes without a basis in the treaty might well be viewed as a precedent, ratifying the right of the Executive Department to grant special exemptions from the tax law by means of an exchange of notes. However, it is noted that the exchange of notes was transmitted to the Senate along with the proposed tax convention and could be viewed as being submitted to the Senate for its advice and consent. If the Executive Department makes it clear that its intent was to request the advice and consent of the Senate on the exchange of notes, then the correspondents and journalists provision could be approved in accordance with the normal procedures for approving treaties.

Fourth, the proposed convention provides that a resident of one country who is temporarily present in the other country for the primary purpose of studying at an educational or scientific research institution or for the purpose of acquiring a profession or a specialty is to be exempt from tax in the host country on a stipend, scholarship, or other substitute type of allowance necessary to provide for ordinary living expenses. The exemption under this provision is not to be for a period exceeding 5 years. In an exchange of notes accompanying the proposed convention, it was agreed that the "ordinary living expenses" would be less than $10,000 (or its equivalent in rubles) for each taxable year to be determined for each student on a case-by-case basis. An exemption for students is generally found in most U.S. tax conventions.

Fifth, the proposed convention provides that a resident of one country who is temporarily present in the other country for the primary purpose of acquiring technical, professional, or commercial experience or performing technical services and who is an employee of, or under contract with, a resident of his country of residence is to be exempt in the source country on remuneration received from abroad. Also, the trainee or specialist is exempt from tax in the source country on amounts received from sources within that country which are necessary to provide for ordinary living expenses. The exemption provided for by this provision is not to apply for a period of more than 1 year. In an exchange of notes accompanying the proposed convention, it was agreed that the exemption in any taxable year is not to exceed an amount in excess of $10,000 (or its equivalent in rubles). An exemption of this type is generally found in U.S. tax conventions; however, it is not extended to individuals performing technical services.

Finally the proposed convention provides that the exemptions provided for individuals which apply to a limited number of years are to be computed on a cumulative basis if more than one exemption applies to an individual. However, in no case are the cumulative benefits to be for more than five taxable years from the date of the individual's arrival in the source country.

If an individual is not entitled to one of these special exemptions provided in the proposed treaty he is to be exempt from tax by the source country if he is present in that country for a period aggregating no more than 183 days in the taxable year. Somewhat similar results are reached under other U.S. income tax conventions.

[15] *Article VII. Citizens*

The proposed convention contains a provision found in most U.S. tax conventions that the convention does not restrict the right of a country to tax its citizens. Thus, for example, the United States may tax its citizens whether or not they are residents of the U.S.S.R. A provision of this nature is found in most U.S. tax conventions; however it generally applies to residents, as well as citizens.

Article VIII. Illegal Activities

The proposed convention provides that the benefits of the convention are available only to the taxation of income from activity conducted in a country in accordance with the law and regulations in force in that country. There is no definition of the laws which are to be taken into account for purposes of this provision. Thus, it would appear that this provision applies to all criminal, civil, and procedural laws and regulations which may be in force in a country at the national, Republic or State, and local level. This feature of the proposed convention makes each treaty country, in effect, the sole judge as to whether it wishes to extend treaty benefits to a particular individual or company since each country would be making a determination as to whether an activity was being conducted in accordance with its laws. It is understood that this article was inserted at the request of the Soviet Union. There is no comparable article to this in any other U.S. income tax convention.

Article IX. Taxes on Transactions

The proposed convention provides that if the income of a resident of one country is exempt from tax under the convention by the other country, the

resident is also to be exempt from any tax which is at present or may subsequently be imposed by the source country on the transaction which gives rise to the income. At the present time the only transaction which will be entitled to a U.S. tax exemption under the proposed convention is the excise tax on insurance and reinsurance premiums paid to a foreign company for the insurance of risks located inside the United States. The rate of tax is presently four cents per dollar of premiums on casualty insurance and one cent per dollar of premium on life, accident, and health insurance and on reinsurance. This excise tax is not frequently imposed since most foreign insurance companies have offices within the United States through which they sell their insurance or reinsurance. No similar provision appears in any U.S. income tax convention.

In an exchange of notes accompanying the proposed convention the two countries agreed that custom duties do not come within the scope of this exemption from taxes on transactions.

Article X. Non-Discrimination

The proposed convention contains a non-discrimination provision which differs somewhat from the more comprehensive non-discrimination provisions which have appeared in more recent U.S. income tax conventions. The proposed convention provides that a citizen of one country who is a resident of the other country is not to be subjected to more burdensome taxes in that other country than a citizen of that other country who is a resident thereof, carrying on the same activities. [16] Further, a citizen of one country who is a resident of the other country, or a representation established by a resident of one country in the other country, is not to be subjected in that other country to more burdensome taxes than are generally imposed in that other country on citizens or representations of residents of third countries carrying on the same activities. In applying this provision, a country is not required to grant to citizens or representations of residents of the other country tax benefits granted by special agreements to citizens or representations of third countries.

It is understood that the reason that the non-discrimination provision is to be determined with reference to treatment of third country representations rather than to local entities such as corporations, as is done in other U.S. tax treaties, is due to the nature of business taxation in the U.S.S.R. The lack of comparable Soviet entities made it more relevant to compare representations of U.S. residents with third country representations. The provisions in this article of the proposed convention apply to all taxes whether imposed at the national, Republic or State, or local level. However, in an exchange of notes accompanying the proposed convention, it was agreed that customs duties are not to be considered as taxes for the purposes of the non-discrimination provisions.

Articles XI and XII. Administrative Provisions

The proposed convention contains some of the various administrative provisions found in other U.S. tax conventions. In general the proposed convention provides for consultation and negotation between the two countries to resolve differences arising in the application of the proposed convention, and also to resolve claims by taxpayers that they are being subjected to taxation contrary to the terms of the proposed convention. Further, the proposed convention provides for notification on an annual basis of any amendments of the tax legislation which is the subject matter of the convention or of any other material concerning the application of the proposed convention.

Article XIII. Entry into Force

The proposed convention will enter into force on the 30th day following the exchange of instruments of ratifications. The provisions of the proposed convention, however, will have effect for income derived on or after January 1 of the year following the year in which the instruments of ratification are exchanged.

Article XIV. Termination

The proposed convention will continue in force indefinitely. However, either country may terminate it at any time after 3 years from its entry into force by giving notice through diplomatic channels. In addition, the provisions of Article III dealing with independent brokers, reinsurance, and interest on credits connected with the financing of trade and the provisions of Article IX dealing with exemptions for transaction taxes may be terminated separately at the end of the 3-year period.

[17] TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE UNION OF SOVIET SOCIALIST REPUBLICS ON MATTERS OF TAXATION, WITH RELATED LETTERS, SIGNED AT WASHINGTON ON JUNE 20, 1973

INTRODUCTION

The Convention deals with the basic matters that are covered in existing income tax conventions to which the United States is a party. However, because of the substantially different economic systems of the United States and the Soviet Union and differences in concept, many of the standard articles in our existing income tax conventions have either been excluded, or modified in substance or form, in the Convention. It is anticipated that the particular formulations that have been used will facilitate increased economic and cultural contacts between the United States and the U.S.S.R. by minimizing the tax barriers which are now or which might become substantial impediments to such contacts.

It is to be noted that the Convention differs substantially from our proposed conventions with Poland and Romania. Although Poland and Romania have economic systems which are similar to the Soviet economic system, those proposed conventions closely resemble our existing conventions rather than the Convention with

the Soviet Union. There are a number of reasons for the difference between the Convention with the Soviet Union and the other two proposed conventions. First, Soviet law does not permit Western companies or individuals to make direct investments in the equity of Soviet commercial enterprises, whereas Romanian law does, and Polish law is expected to, permit direct investment in enterprises organized in those countries. Second, the Soviet income tax system may be considered to be in its formulative stage as respects international business transactions, and lacks many of the features of Western income tax systems, whereas the Polish and Romanian income taxes imposed on nonresident individuals and foreign corporations generally resemble similar income taxes imposed by Western countries. Finally, it should be noted that the Convention is the first comprehensive income tax convention which the Soviet Union has negotiated or signed with a non-socialist country, whereas Poland and Romania had already signed several income tax conventions with Western countries before negotiating their conventions with the United States. In addition, Poland and Romania also had income tax conventions in effect before World War II.

ARTICLE I: TAXES COVERED

This article designates the taxes and dues of the respective States which are the subject of the Convention. The Convention, using parallel language with respect to both Contracting States, applies to "taxes and dues" because the Soviet Union uses the term "dues" to designate [18] certain taxes covered by the Convention. However, with respect to the United States, the term "dues" is intended to have the same meaning as the term "taxes."

With respect to the Soviet Union, the taxes and dues covered by the Convention are defined in subparagraph (a) of paragraph 1 as those provided for by the All-Union legislation of the Soviet Union. The term "All-Union legislation" is not meant to refer to a specific law or code but is a generic term covering legislation at the national level that applies throughout the Soviet Union. The taxes imposed by the Union Republics of the Soviet Union (comparable to states of the United States) are not covered by the Convention because, in keeping with past U.S. policy the taxes of the state and local governments of the United States are excluded from the scope of the Convention, except for purposes of Article X (Nondiscrimination). However, such taxes are a minor source of revenue in the Soviet Union.

Although the Soviet Union does impose income taxes on Soviet citizens who are either salaried or self-employed, as well as on Soviet commercial and industrial enterprises, the Soviet Union generally does not impose income taxes either on corporations organized outside the Soviet Union which are doing business in the Soviet Union, or on citizens of other countries (other than certain foreign correspondents) who work in the Soviet Union for an employer other than a Soviet enterprise. Similarly, the Soviet Union generally does not impose withholding taxes on payments made by a Soviet citizen or a Soviet enterprise to a non-Soviet citizen or corporation, such as interest payments on loans, royalities on licensed technology, or service fees. However, the Soviet tax authorities are believed to be considering the imposition of withholding taxes such as those imposed by other countries on these and similar payments made to nonresidents. In late 1973 the first Soviet withholding tax was enacted in the form of a tax on copyright royalties paid to nonresidents. This tax is imposed at whatever rate is imposed by the country where a recipient of royalties resides on copyright royalties paid to a Soviet citizen. Thus, a tax at the rate of 30 percent applies in the case of royalty payments to the United States. In addition, a withholding tax of approximately 5 percent is imposed on reinsurance premiums received by a foreign insurance company from the Soviet Union.

With respect to the United States, the taxes covered by the Convention are defined in subparagraph (b) of paragraph 1 to include all taxes imposed by the Internal Revenue Code. In theory, therefore, the Convention covers not only income taxes, but all other taxes imposed by the Internal Revenue Code such as estate and gift taxes and excise taxes as well. In most cases, however, such other taxes would only be covered for purposes of Article IX (Taxes on Transactions), Article X (Nondiscrimination), Article XI (Mutual Agreement), and Article XII (Notification of Changes in Law). Since most other articles of the Convention relate to taxes imposed by either country upon income, in general the only U.S. taxes affected by those articles would be taxes on income. Thus, all of the taxes imposed by Subtitle A of the Internal Revenue Code (entitled "Income Taxes") are covered by the Convention for purposes of those articles, to the extent that a particular tax imposed thereunder is imposed on income. However, [19] certain other taxes imposed by the Internal Revenue Code, to the extent that they are also imposed on income, are also covered for purposes of those articles, even though they are not specifically designated as "income taxes" in the Internal Revenue Code. Thus, the Federal social security tax imposed on employees by section 3101 is covered by the Convention because it is imposed on income, as are the 4 percent excise taxes imposed on the investment income of foreign private foundations by sections 4940 and 4948.

For purposes of Article X (Nondiscrimination), the Convention applies to taxes of every kind imposed in the United States at the Federal, state or local level. For purposes of the same article, the Convention applies to taxes of every kind imposed in the Soviet Union at the national, republic, or local level. However, taxes at the republic or state level, or at the local level, are not covered by the Convention for purposes of any other article of the Convention.

Paragraph 2 of this article provides

that the Convention shall also apply to taxes and dues that are substantially similar to the taxes covered by the Convention and which are imposed after the date the Convention was signed (June 20, 1973) in addition to, or in place of, existing taxes and dues.

ARTICLE II: DEFINITIONS

This article defines some of the most important terms used in the Convention. However, several terms are defined elsewhere in the Convention.

Paragraphs 1 and 2 provide that, when used in a geographical sense, the terms "Soviet" or "USSR" and "United States" or "USA" include the territories of the Union Republics and the states and District of Columbia, respectively, the territorial sea of each country, and certain continental shelf areas of each country as well. This definition is similar to that included in the definition of the term "United States" in section 638 of the Internal Revenue Code for purposes of chapter 1 thereof.

Paragraphs 3 and 4 of this article define the terms "resident of the Soviet Union" and "resident of the United States" respectively. The term "resident of the Soviet Union" means a legal entity, or any other organization treated as a legal entity by the Soviet Union for purposes of its tax laws, which is created under the laws of the Soviet Union or of any Union Republic, as well as an individual who is resident in the Soviet Union for purposes of its tax laws. The term "resident of the United States" includes a corporation, or any other organization treated as a corporation for federal tax purposes, which is created or organized under the laws of the United States, any state of the United States, or the District of Columbia. The term also includes an individual who is resident in the United States for Federal income tax purposes. For purposes of the Convention, a citizen of the Soviet Union is not automatically a resident of the Soviet Union and a citizen of the United States is not automatically a resident of the United States. If an individual is considered a resident of both States and that such a dual classification results in taxation not in accordance with the Convention, it is intended that he would seek relief under Article XI (Mutual Agreement).

[20] Although the Convention does not expressly provide that a partnership, trust, or estate can be classified as a "resident" of either the United States or the Soviet Union, it is intended that a partnership, trust, or estate can be so classified and can be eligible for the benefits accorded by the Convention. This interpretation of the Convention is consistent with the principles of the Internal Revenue Code which generally treat partnerships, trusts, and estates in the same manner as individuals, subject in some cases to certain special rules. However, it is intended that a partnership, trust, or estate can qualify as a resident of either the United States or the Soviet Union only to the extent that the income derived by such entity is subject to tax in either country as the income of a resident. Thus, for example, if a Soviet enterprise enters into a joint venture agreement with a Polish enterprise and the joint venture receives income from United States sources which is entitled to an exemption under the Convention, it is intended that the share of such income which is allocable to the Soviet enterprise will be entitled to an exemption from U.S. tax if such allocable portion of income is taxable to the Soviet enterprise under Soviet tax law as the income of a resident.

The term "Contracting State" is defined in paragraph 5 of this article to mean the United States or the Soviet Union, as the context requires.

The term "competent authorities" is defined in paragraph 6 of this article to mean the Ministry of Finance in the case of the Soviet Union, and the Secretary of the Treasury or his delegate in the case of the United States.

This article does not contain a provision similar to that in our recent income tax conventions stating that a term which is used in the Convention but which is not defined therein shall have the meaning which it has under the laws of the Contracting State whose tax is being determined. In accordance with generally accepted principles relating to the interpretation of tax conventions, however, it is intended that such a rule is implied by the Convention. If the same term has different meanings under the laws of both States, or where its meaning under the laws of either State is not clear, the competent authorities may establish a common meaning for purposes of the Convention.

ARTICLE III: EXEMPT ITEMS OF INCOME

Paragraph 1 of this article provides that certain items of income which are derived from sources within one of the Contracting States by a resident of the other Contracting State shall be exempt from tax by the former. Thus, for example, a resident of the United States deriving income of a type described in paragraph 1 from sources within the Soviet Union would not be subject to tax on such income in the Soviet Union. Although the exemptions in paragraph 1 are limited to income derived from sources within one Contracting State by a resident of the other Contracting State, it is intended that the exemption applies equally to income from sources outside a Contracting State which is taxable in that State as income effectively connected with the conduct of a trade or business within that state. Thus, for example, items of income described in section 864(c)(4)(B) of the Internal Revenue Code which are received by a resident of the Soviet [21] Union will be exempt from U.S. tax under this article if the same items of income would be exempt from U.S. tax under this article if from sources within the United States.

Effect of saving clause for citizens

The provisions of this article are subject to the saving clause of Article VII (Saving Clause for Citizens). Thus, the exemptions of this article do

not apply to citizens of the taxing State.

Exemptions not affected by a "representation"

The provisions of this article apply even if the recipient of the income has a "representation" in the State of source and the rights or property giving rise to the income are effectively connected with such representation. (As defined in paragraph 2 of Article IV (Representation), a representation is essentially the same as a "permanent establishment" under our existing treaties.) The income specified in this article may not be taxed in the State where the representation deriving the income is situated even though the representation is subject to tax under Article IV on income derived in that State. Thus, the exemptions in this article are broader than under our other income tax conventions.

Related persons

If an item of income described in paragraph 1 is paid by a person that is related to the recipient of the income, the exemption under this article is intended to apply only to so much of the income as would have been paid to an unrelated person, and the excess portion of the income may be taxed by the State in which the income has its source in accordance with its domestic law. It was understood in the negotiations that such a rule should be applied where appropriate in determining what income comes within the categories described in this paragraph even though this rule was not expressly included in the Convention in order to avoid any implication that a resident of the United States might be able to acquire an equity interest in a Soviet enterprise. Thus, if a representation of a resident of the United States or of a resident of a third country which is maintained in the Soviet Union makes a payment to a related resident of the United States which is in excess of an amount which would be paid to an unrelated person, the excess portion may be subject to Soviet tax in accordance with whatever Soviet laws are in effect at the time the payment is made (although at the present time it does not appear that any Soviet taxes would be imposed on any portion of the payment, including the excess portion). Similarly, if an item of income subject to U.S. tax were paid by any person to a related resident of the Soviet Union, the United States would be entitled to tax any excess portion in accordance with the rules of section 482 of the Internal Revenue Code as if the Convention had not come into effect. For purposes of this rule, a person is considered to be related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control both such persons either directly or indirectly.

Exemption for certain rentals, royalties, etc.

The items of income enumerated in subparagraph (a) of paragraph 1 are rentals, royalties, and certain other amounts paid for the use of, [22] or the right to use, copyrights of literary, artistic, or scientific works, patents (including author's certificates which are issued in the Soviet Union in lieu of patents), industrial designs, processes or formulae, computer programs, trademarks, service marks, or other similar property or rights or for industrial, commercial, or scientific equipment, or for knowledge, experience, or skill (know-how), and, in subparagraph (b) gains derived from the sale or exchange of such rights or property whether or not payment is contingent on the extent and nature of use or disposition of the rights or property. It is intended that copyrighted films and tapes are included within the scope of subparagraphs (a) and (b) even though they are not specifically mentioned.

At the time of the negotiations, the Soviet Union did not tax royalties paid to nonresidents, but, as indicated above, since late 1973 copyright royalties paid to nonresident authors have been subject to withholding tax at the same rate imposed by the recipient's country on royalties to authors in the U.S.S.R.

Exemption for inherited property

Subparagraph (c) of paragraph 1 provides that gains derived from sources within one of the Contracting States by a resident of the other Contracting State from the sale or disposition of real or personal property received by way of inheritance or gift shall be exempt from tax by the former Contracting State. The exemption does not affect the U.S. estate tax imposed on property bequeathed to a resident of the Soviet Union but only provides an exemption from the U.S. capital gains tax imposed upon the disposition of the inherited property. Under present law there would usually be no U.S. tax on the gain unless the recipient of the gain were present in the United States for 183 days or more during the taxable year, and if he were present in the United States for such a period the amount of the gain would often be small because of the stepped-up basis which the inherited property would acquire under section 1014 of the Internal Revenue Code. The exemption was included in this article because the Soviet Union considered it important for the Convention to include an exemption on inherited property. The U.S. Treasury Department and the Soviet Ministry of Finance agreed further to discuss an estate tax treaty at some time in the future.

Exemption for certain technical services

Subparagraph (d) of paragraph 1 provides that income from engineering, architectural, designing, and other technical services derived from sources within one of the Contracting States that are furnished in connection with an installation contract with a resident of such State shall be exempt from tax in such State. To be exempt, such services must be performed over a period not in excess of 36 months at any one location. Thus, if any such services extend for a period in excess of 36 months, no exemption would be applied for any part of the initial 36-

month period. Similar rules with different time limitations are contained in the definition of the term "permanent establishment" in many of our other income tax conventions. The longer time period should be of benefit to U.S. firms, since installation and construction activities associated with the sale of equipment and know-how commonly require extended periods of time.

[23] *Exemption for sale of goods and services*

Subparagraph (e) of paragraph 1 provides that income derived from sources within one of the Contracting States from the sale of goods or the supplying of services through a broker, general commission agent, or any other independent agent shall be exempt from tax in such State. This provision does not exempt the broker or agent from tax but only the enterprise making use of the broker or agent. Pursuant to an exchange of letters between the United States and the Soviet Union at the signing of the Convention, it is agreed that a Soviet foreign trading organization performs the functions of a broker or general commission agent, so that a representation of a resident of the United States which is maintained in the Soviet Union and which makes sales to a Soviet foreign trading organization (Soviet legal entities controlled by the Soviet Ministry of Foreign Trade and which control all Soviet import-export trade) will be regarded as making sales through a broker or general commission agent for purposes of the exemption in subparagraph (e) of paragraph 1. The exemption would also apply, of course, even if the resident of the United States did not maintain a representation in the Soviet Union but made sales to a Soviet foreign trading organization in the same manner. Similarly, a Soviet foreign trading organization which receives U.S.-source income from the sale of goods in the United States will be exempt from U.S. tax on such income if the sales are made through an independent broker, even if the foreign trading organization maintains a representation in the United States. However, the exchange of letters states the understanding of the parties that a firm acting in the United States as a broker, general commission agent or other agent for a Soviet foreign trading organization will not be considered to be of independent status if it is owned or otherwise controlled by an authorized organization of the Soviet Union. Because a resident of the United States under present Soviet law may not sell goods directly to the ultimate purchaser of the goods in the Soviet Union but in all cases must sell the goods to a Soviet foreign trading organization, the exemption in this subparagraph will be of substantial benefit to U.S. exporters to the Soviet Union, by exempting virtually all of their sales income from Soviet tax.

The exemption in subparagraph (e) of paragraph 1, as amplified by the exchange of letters, applies not only to income from the sale of goods but to income from the supplying of services. For example, a Soviet foreign trading organization which receives income from U.S. sources for the furnishing of tour performances will be exempt from U.S. tax on such income if the tour performances are furnished through an independent impresario or similar independent agent. The exemption would apply even if the foreign trading organization maintained a representation within the United States to which such income was attributable, within the meaning of Article IV (Representation). The exchange of letters states the understanding of the parties that the exemption will also apply to a resident of the United States who supplies services to a Soviet foreign trading organization.

Exemption for reinsurance premiums

Subparagraph (f) of paragraph 1 provides that premiums from the reinsurance of property or risks derived from sources within one [24] of the Contracting States by a resident of the other Contracting State shall be exempt from tax in the first State. However, premiums or other income from other kinds of insurance activities are not exempt under this paragraph, although they may be exempt under paragraph (1) of Article IV (Representation) if the resident of the other State does not have a representation in the first State to which such premiums or other income are attributable. The effect of this subparagraph is to exempt a resident of the United States from the Soviet tax on reinsurance premiums, discussed above under Article I (Taxes Covered).

Exemption for interest on certain loans

Subparagraph (g) of paragraph 1 provides that interest on credits, loans, and other indebtedness connected with the financing of trade between the two Contracting States derived from sources within one of the Contracting States shall be exempt from tax in such State. Thus, a resident of the United States will be exempt from Soviet tax on interest received on loans used to finance sales to residents of the Soviet Union. However, interest is not exempt under subparagraph (g) if derived by a resident of one Contracting State from the conduct of a general banking business in the other Contracting State.

Relation to Article VI

Although income which an individual resident of one Contracting State earns from the performance of services in the other Contracting State is primarily covered by Article VI (Exceptions for Individuals), in certain cases an individual may receive services income which is entitled to exemption under this article and which is not subject to the rules in Article VI. For example, where an individual who is a resident of one State is self-employed or is a member of a partnership, and where he or his partnership receives income from sources within the other State for the performance of services which are described in subparagraphs (d) (technical services in connection with an installation contract), or (e) (supplying of services through an independent agent), such income would be exempt from tax in the other State even though the individual

were present in that State for more than 183 days in the taxable year within the meaning of paragraph 2 of Article VI. However, income which a resident of one State received for the performance of services as an employee would always be subject to the rules in Article VI, including paragraph 2 thereof, and would not qualify for exemption under this article. Because most individual residents of the Soviet Union receiving U.S.-source services income will be classified as employees, it is anticipated that this rule will apply principally to residents of the United States who receive Soviet-source services income described in paragraph 1 of this article, and who have chosen not to conduct business in incorporated form.

Taxfree activities

Paragraph 2 of this article provides that no taxable income shall be attributed to specified activities conducted within one Contracting State by a resident of the other. These activities are: (a) the purchase of goods or merchandise for the resident; (b) the use of facilities for the purpose of storage or delivery of goods or merchandise belonging to the resident; (c) the display of goods or merchandise belonging to [25] the resident, including the sale of such items on termination of their display as do not constitute a part of the resident's inventory; and (d) advertising, collecting and disseminating information, conducting scientific research, and similar activities, for the account of the resident provided that in each of the foregoing cases they have a preparatory or auxiliary character for the resident. More than one of the foregoing activities may be performed without the attribution of taxable income to them. The enumerated activities appear with certain minor differences in other existing income tax conventions as activities which will not cause a permanent establishment to exist. However, the exemption for purchasing activities is usually contained in the rules concerning business profits rather than in the definition of the term "permanent establishment." See, for example, paragraph 4 of Article 5 (Business Profits) of our convention with Norway.

ARTICLE IV: REPRESENTATION

Paragraph 1 of this article sets forth the rule that income from commercial activity derived in one Contracting State by a resident of the other Contracting State shall be taxable in the first State only if derived by a "representation" of the resident in that State. Where the resident does have a representation in the first State, income from commercial activity may be taxed by such State but only if it is attributable to the representation. Paragraph 5 of this article makes clear, however, that the exemptions from tax under Article III (Exempt Items of Income) and Article V (Ships and Aircraft) are not effected by this article. Thus, if a resident of the Soviet Union has a representation in the United States which derives income from commercial activity which is described in Articles III or V, the exemption provided in those articles would still apply.

Effect of saving clause for citizens

The principles of this article are subject to the savings clause of Article VII (Saving Clause for Citizens). Thus, the exemption provided for by paragraph 1 of this article does not apply to citizens of the taxing State.

Income from commercial activity

Although the term "income from commercial activity" in paragraph 1 of this article is not defined in the Convention, in general such term includes items of income which are defined in our existing treaties as "business profits" or "industrial or commercial profits," such as income from the conduct of manufacturing, merchantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, and the furnishing of services. In practice, however, in the case of certain of these activities the exemption provided in this article at the present time could only apply to income derived by a resident of the Soviet Union from the United States, because present Soviet law prohibits nonresidents from engaging in certain kinds of commercial activity within the Soviet Union.

Income derived from a State

It is intended that income from commercial activity can be treated as "derived in one Contracting State" for purposes of paragraph 1 of [26] this article if the income is from sources either within or without a Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Internal Revenue Code which are realized by a resident of the Soviet Union will be exempt from U.S. tax under this article if the same item of income would be exempt from U.S. tax under this article if from sources within the United States. See the commentary under Article III above. However, if items of income described in section 864(c)(4)(B) are derived by a representation in the United States of a resident of the Soviet Union, such amounts will be subject to U.S. tax unless otherwise exempted under Article III of Article V.

Self-employed individuals

Where an individual who is a resident of one of the Contracting States is self-employed or is a member of a partnership and where he or his partnership derives income in the other Contracting State from the performance of services, the income will be subject to the rules in this article (to the extent not overridden by Articles III or V) and not to the rules in Article VI (Exemption for Individuals) if the income is "income from commercial activity" within the meaning of paragraph 1. Thus, individual residents of the United States who are members of a partnership that receives a fee for commercial services rendered within the Soviet Union will be exempt from Soviet tax on the fee even if they are present in the Soviet Union for more than 183 days during the taxable year within the meaning of paragraph 2 of Article VI, provided that neither the partnership nor the individual partners has a representation

within the Soviet Union. However, income from professional services received by a self-employed professional would not be subject to the rules in Article IV but would be subject to the rules in Article VI, including paragraph 2 thereof.

Definition of "representation"

Paragraph 2 of this article defines the term "representation". This term was used instead of the term "permanent establishment" (the comparable term used in our existing treaties) because the term "representation" is a recognized term under Soviet law, and because the same term is used in Article 6 of the Trade Agreement of October 18, 1972, between the United States and the Soviet Union, relating to the establishment of business offices in either country by a resident of the other. However, the term "representation" as defined in paragraph 2 is not intended to have precisely the same meaning that it may have for purposes of Article 6 of the Trade Agreement.

The definition of the term "representation" is slightly different, depending on whether income is derived in the Soviet Union or in the United States. With regard to income derived within the Soviet Union, the term "representation" is defined in subparagraph (a) to mean an "office or representative bureau" established in the Soviet Union by a resident of the United States in accordance with the laws and regulations of the Soviet Union. With regard to income derived from within the United States, however, the term is defined in subparagraph (b) to mean an "office or other place of business" established in the United States by a resident of the Soviet Union in accordance with the laws and regulations in force in the United States.

[27] The term "office or representative bureau" was used in subparagraph (a) in recognition of the fact that a resident of the United States in general is not permitted to engage in any substantial continuous business activity within the Soviet Union unless he has an "office or representative bureau" which is established there within the meaning of specific Soviet laws and regulations which are in force at the national level. The phrase "established in the U.S.S.R. . . . in accordance with the laws and regulations in force in the Soviet Union" was used to make clear that the Convention does not operate to authorize a resident of the United States to set up an office or representative bureau other than in accordance with such laws and regulations.

In the case of the United States, there is no federal legislation which restricts or regulates the establishment or maintenance by a resident of the Soviet Union of business operations within the United States (other than laws regarding the issuance of entry visas to Soviet citizens who will conduct such operations), although most of the states would require an incorporated legal entity of the Soviet Union to obtain a special license or certificate of authority if it were "doing business" within the state. Thus, it was intended that all of the facts and circumstances would be examined in determining whether a resident of the Soviet Union has a "representation" in the United States, rather than the terms of any particular domestic legislation. Accordingly, the somewhat broader term "office or other place of business" was used in subparagraph (b). The phrase "established in the U.S.A. . . . in accordance with the laws and regulations in force in the United States" was included in subparagraph (b) for purposes of reciprocity, to evidence an understanding that residents of the Soviet Union with offices or other places of business in the United States should comply with U.S. laws in connection with those places of business. However, if a resident of the Soviet Union maintains an office or other place of business in the United States but does not obtain a license to do business if so required under the laws of the state where the office or other place of business is located, the resident would still be deemed to have a "representation" in the United States for purposes of the Convention.

Although the term "office or other place of business" is not further defined in subparagraph (b) of paragraph 2 of this article, the term is intended to have much the same meaning as the term "fixed place of business" in our other recent income tax conventions. Thus, the term would include a branch, an office, a factory, a workshop, a warehouse, and a mine, quarry, or other place of extraction of natural resources. See Article 4 of our convention with Norway. The term would also include a building site or construction or installation project, but certain income realized in connection with a site or project which was maintained for 36 months or less at one location would be exempt from tax under subparagraph (d) of paragraph 1 of Article III.

Expenses of a representation

Paragraph 3 of this article provides that expenses (wherever incurred) which are reasonably connected with profits attributable to the representation, including executive and general administrative expenses, shall be allowed as deductions by the Contracting State in [28] which the representation is located in computing the tax due to such State. Such deductions would be allowed whether the expenses were incurred in such State or elsewhere, but the deductions so allowed may be limited to expenses actually incurred without including a profit element for the head office in the other State.

Tour performances and public appearances

Paragraph 4 of this article simply makes explicit, at the request of the Soviet Union, that this article applies to income from tour performances and public appearances. Thus, for example, a resident of the Soviet Union, such as a production organization or an impresario, furnishing a tour performance in the United States, is not subject to United States tax on the income from such performance unless

the resident maintains a representation in the United States to which such income is attributable (subject in such case to the overriding exemption in subparagraph (e) of paragraph 1 of Article III). The income of a tour member (whether employed or self-employed) attributable to his personal services while on tour is not covered under this article, but is covered instead by Article VI.

ARTICLE V: SHIPS AND AIRCRAFT

Under paragraphs 1 and 2 of this article, income which a resident of a Contracting State derives from the operation in international traffic of ships or aircraft registered in such Contracting State shall be exempt from tax in the other Contracting State. In addition, gains derived by a resident of one Contracting State from the sale, exchange, or other disposition of ships or aircraft operated in international traffic and registered in the Contracting State are exempt from tax by the other Contracting State. The exemptions in paragraphs 1 and 2 are granted even if the resident of the first Contracting State has a representative in the other Contracting State and even if such income is derived within that State by the representation within the meaning of Article IV (Representation). However, the exemptions do not apply to citizens of the taxing State, by operation of Article VII (Saving Clause for Citizens).

It is understood that income from the operation in international traffic of ships or aircraft by a resident of one of the Contracting States includes income derived from the use, maintenance, and lease of containers and similar items and related equipment in connection with such operations. Thus, such income would be exempt from tax in the other Contracting State under paragraphs 1 and 2 of this article. This interpretation is consistent with the rules applicable under our recent income tax conventions with Japan and with Norway.

Paragraph 3 of this article provides that income from labor or personal services performed by an individual as an employee aboard ships or aircraft operated by a Contracting State or by a resident thereof in international traffic is exempt from tax by the other Contracting State if such employee is a member of the regular complement of the ship or aircraft. Similar provisions are found in our other income tax conventions. The exemption under paragraph 3 would be available to an individual who is a resident of either Contracting State, or of a third State, but the exemption would not be available to an individual who [29] is a citizen of the taxing State because of the operation of Article VII (Saving Clause for Citizens).

The exchange of letters accompanying the Convention provides that, if the occasion arises, each State will use its best offices to secure exemption from income taxation at the republic or state, or local, levels which may be imposed on the operation of ships and aircraft. This commitment was occasioned by the fact that state and local taxes are not covered by the Convention.

ARTICLE VI: EXEMPTIONS FOR INDIVIDUALS

This article contains most of the exemptions which are granted by the Convention to individuals. The exemptions correspond to the exemptions for individuals that are granted in our existing conventions, except that a few of the exemptions are broader than the comparable exemptions in the existing conventions. In addition, the comparable exemptions in our existing conventions are usually contained in several articles instead of in one article. None of the exemptions contained in this article are available to an individual who is a citizen of the taxing State, because of the operation of Article VII (Saving Clause for Citizens).

Governmental employees

Subparagraph (a) of paragraph 1 of this article exempts from taxation by one of the Contracting States remuneration paid by the other Contracting State to an individual who is a citizen of that other Contracting State for labor or personal services performed as an employee of a governmental agency or institution of such other State in the discharge of governmental functions. Subdivision (2) of subparagraph (a) states further that labor or personal services shall be considered as performed in the discharge of governmental functions if so treated by the law of the State of which the individual is a citizen, but the subdivision makes clear that individuals who are engaged in commercial activities are not considered to be engaged in the discharge of governmental functions.

While most citizens of the Soviet Union work indirectly for the Soviet government, most would not qualify for exemption from tax in the United States under subparagraph (a) because they do not work directly for a governmental agency or institution of the Soviet Union, and many tof those who do would still not be entitled to exemption under subparagraph (a) because they are engaged in commercial activity. For example, employees of Aeroflot, the commercial passenger airline operated by the Soviet government, would not be entitled to exemption under subparagraph (a) even if they were directly employed by a Soviet governmental agency or institution. Normally, therefore, a Soviet citizen would have to work for a Soviet government ministry in order to qualify for the exemption. The determination whether a particular activity is a "commercial activity" would be made, for purposes of ascertaining whether an individual resident of the Soviet Union qualified under subparagraph (a) for exemption from tax, in accordance with the principles set forth in Rev. Rul. 66-73, 1966-1 C.B. 174. See the last paragraph of the commentary under Article II (Definitions), above.

[30] Subdivision (3) of subparagraph (a) makes clear that the fiscal privileges granted to diplomatic and consular officials under the general rules of international law or under special

agreements are not affected by the Convention.

Participants in programs of intergovernmental cooperation

Subparagraphs (b) and (f)(1) of paragraph 1 provide that a resident of one Contracting State who is temporarily present in the other Contracting State under an exchange program provided for by an agreement between the national governments of the Contracting States on cooperation in various fields of science and technology shall not be subject to tax in such other State on remuneration received from sources within either State, for a period not exceeding one year. If the individual's visit as a participant in such a program exceeds one year, the exemption applies to the income received by the individual before the expiration of such one-year period. However, the remuneration must be received in connection with the individual's participation in such exchange program. The exemption in this subparagraph differs somewhat from comparable exemptions that are included in our recent income tax conventions. Those conventions generally provide that residents of one State who are temporarily present in the other State for up to one year for the primary purpose of training, research or study as a participant in a program sponsored by that State, shall be exempt from tax by that State on up to $10,000 in income from personal services in respect of such training, research, or study. See, for example, Article 16(3) of our convention with Norway.

The exemption granted by subparagraph (b) of paragraph 1 of this article of the Convention, however, applies only if the individual who is a resident of one State is present in the other State pursuant to an intergovernmental agreement on cooperation (of which thirteen are now in effect between the United States and the Soviet Union), whereas under our recent conventions an individual can qualify for exemption in certain situations where no such agreement exists. On the other hand, the exemption granted by subparagraph (b) is broader than the comparable exemption in our recent conventions in that the exemption can apply where an individual who is a resident of one State participates in a program sponsored by a private organization in the other State rather than a government agency of that State, so long as the program is conducted pursuant to an international cooperation agreement. In addition, the exemption granted by subparagraph (b) is somewhat broader in that there is no dollar limitation on the amount of the exemption.

Teachers and researchers

Subparagraphs (c) and (f)(2) of paragraph 1 provide that an individual who is a resident of one of the Contracting States and who is temporarily present in the other Contracting State at the invitation of a governmental agency or institution or an educational or scientific research institution in that other State for the primary purpose of teaching, engaging in research, or participating in scientific, technical or professional conference is exempt from tax in that other State on his remuneration from such activities for a period not exceeding two [31] years. If the individual's visit as a teacher or researcher exceeds a period of two years, the exemption still applies to the income received by the individual before the expiration of such two-year period. Similar results are reached under our recent income tax conventions. In the case of researchers, the exemption granted by subparagraph (e) does not apply to income from research undertaken primarily for the benefit of a private person, including a commercial enterprise in the case of the United States, and a foreign trading organization in the case of the Soviet Union. Nevertheless, income from research conducted pursuant to an intergovernmental agreement on cooperation would still be exempt, regardless of the beneficiary of the research.

Pursuant to the exchange of letters between the Soviet Union and the United States, it is agreed that the exemption accorded researchers and teachers shall extend to journalists and correspondents with respect to compensation received from abroad for periods not exceeding two years. For this purpose it is not necessary that the correspondents be invited by the host state, and it does not matter whether they are employed by a private person or commercial enterprise. Such an exemption is not contained in any of our existing income tax conventions, but it was agreed to in this case for two reasons. First, both the United States and the Soviet Union retain income tax jurisdiction over their nonresident citizens, unlike most other countries. Second, the Soviet Union exempts foreign correspondents working in the Soviet Union from Soviet income tax only if a particular correspondent's country of citizenship also exempts Soviet correspondents working in that country from its income tax, and most foreign countries with correspondents working in the Soviet Union have granted such an exemption to Soviet correspondents under their internal law. Therefore, an individual resident of the United States who works as a correspondent in the Soviet Union will be exempt from Soviet income tax for two years by reason of the Convention, in the same manner as correspondents from third countries are now exempt.

Students

Under subparagraphs (d) and (f)(3) of paragraph 1, stipends, scholarships, and other substitute types of allowances (including gifts and grants) received by a resident of one of the Contracting States who is temporarily present in the other Contracting State for the primary purpose of study at an educational or scientific research institution or securing training for qualification in a profession or specialty shall be exempt from taxation in such other Contracting State for a period not exceeding 5 years. If the individual's visit as a student exceeds a period of 5 years, the exemption still applies to the amounts received by the individual before the expiration of such 5-year period. Similar results are

reached under our recent income tax conventions. However, the exemption only applies to such amounts as are necessary to provide for the individual's ordinary living expenses (including tuition payments). Pursuant to an exchange of letters, it was agreed that the amount exempted under subparagraph (d) will not exceed, and will generally be less than, $10,000, or its equivalent in rubles) for any taxable year and will be determined for students on a case-by-case basis.

[32] It is intended that where a resident of the Soviet Union qualifies for exemption under subparagraph (d) of paragraph 1, and under section 117 of the Internal Revenue Code, the more favorable exemption is to be applied, but not both at the same time. For example, an individual who received a fellowship grant of $12,000 would not be entitled to the exemption of $3,600 which is granted by sections 117(a) and (b)(2)(B) of the Internal Revenue Code, in addition to the exemption of $10,000 (or such lesser amount as may be applicable) under the Convention.

Trainees and specialists

Subparagraph (e) of paragraph 1 grants an exemption to an individual who is a resident of one State and who is temporarily present in the other State for the primary purpose of acquiring technical, professional, or commercial experience or for the primary purpose of performing technical services, provided that the individual is an employee of, or under contract with, a resident of the first State. However, the exemption is limited to remuneration receive dfrom abroad from the resident of the first State of which the individual is an employee or with which he is under contract, and to amounts which are necessary to provide for ordinary living expenses, and which are received from sources within the State where the individual acquires such experience or performs technical services. In addition, it was agreed in the exchange of letters that the exemption for amounts necessary to provide for ordinary living expenses may not exceed $10,000 or its equivalent in rubles.

The exemption in subparagraph (e) is limited by subparagraph (f)(i) to a period of one year, although an individual who remained more than one year would still qualify for the exemption during the first year of his presence in the other State.

The exemption granted in subparagraph (e) to trainees and specialists is somewhat broader than the comparable exemption in our existing treaties. Not only is the $10,000 limit on the exemption for living expenses greater than the similar exemption in our recent treaties (which is usually limited to $5,000), but the exemption is granted to individuals who perform technical services in the other State as well as trainees who are there for the primary purpose of acquiring experience. The exemption for individuals performing technical services is expected primarily to benefit U.S. technicians who assist in the installation and operation of U.S. equipment in the Soviet Union.

Duration of exemptions

Subparagraph (f) of paragraph 1 provides that the exemptions in subparagraphs (b) through (e) are limited to the time required to effectuate the purpose of the visit, but may in no case be longer than the periods specified. If an individual qualifies for exemption under more than one of these provisions, the provision most favorable to him shall be considered to apply. In no case, however, shall the cumulative benefit of periods of exemption under such paragraph exceed 5 years from the date of the individual's arrival.

Other individuals

Paragraph 2 of this article provides that, except for the exemptions specified above in paragraph 1, income derived by an individual resident of one State from the performance of personal services in the [33] other State, may be taxed in that other State only if the individual is present in that other State for a period aggregating more than 183 days in the taxable year. This paragraph applies to the salary of any individual who works as an employee, and any self-employed individual (including a member of a partnership) who performs professional services rather than commercial services covered by the rules in paragraph 1 of Article IV (Representation). For this purpose the term "professional services" includes independent, scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants, to the extent that any such activities are not specifically covered by subparagraph (b) through (e) of paragraph 1 of this article.

The exemption granted by paragraph 2 is somewhat broader than the comparable exemption in our existing income tax conventions. Although most other conventions require (as does paragraph 2 of this article) that an individual resident of one State must be present in the other State for less than 183 days during a year in order for his income from the performance of personal services to be exempt from tax in that other State, certain additional tests must usually be satisfied where the individual works either as an employee or where he is self-employed.

ARTICLE VII: SAVING CLAUSE FOR CITIZENS

This article provides that the Convention shall not restrict the right of a Contracting State to tax a citizen of that Contracting State. Thus, the United States may continue to tax its citizens whether or not they are residents of the Soviet Union within the meaning of paragraph 3 of Article II (Definitions). Similar provisions are contained in all our existing income tax conventions, except that this article does not apply to residents of the United States who are not its citizens. Thus, an individual who was treated as a resident of the United States under the Internal Revenue

Code but who is also a resident of the Soviet Union within the meaning of paragraph 3 of Article II could not be denied an exemption which is granted by the Convention to residents of the Soviet Union. However, the United States would be entitled to tax such an individual as a resident to the extent of any income not affected by the Convention.

ARTICLE VIII: ILLEGAL ACTIVITIES

Under this article, the benefits of the Convention are granted only with respect to the taxation of income from activity conducted in a Contracting State in accordance with the laws and regulations in force in such State, whether at the national, republic or state, or local level. This article was included at the request of the Soviet Union, and no comparable article is contained in any existing income tax conventions. Although the provisions of this article could be viewed as denying the benefits of the Convention whenever even a minor infraction of the laws of a Contracting State took place (for example, if a particular income tax return were filed beyond the deadline for filing), the article is intended to apply only when an activity violates a public policy of major concern to a State.

[34] ARTICLE IX: TAXES ON TRANSACTIONS

This article provides that if the income of a resident of a Contracting State is exempt from tax in the other Contracting State by reason of the Convention, the resident shall also be exempt from any tax which is now imposed or which may subsequently be imposed by such other Contracting on the transaction giving rise to such income. Thus, for example, if the Soviet Union were to impose a turnover tax on the recipient of a royalty for a patent licensed to a Soviet resident, this article would provide exemption from such a tax because the royalty would be exempt from income tax under subparagraph (a) of paragraph 1 of Artilce III. A resident of the Soviet Union would be exempt from a comparable U.S. turnover tax in the reverse situation. At the present time the only U.S. tax which would be affected by this article would be the stamp tax on insurance and reinsurance premiums imposed by section 4371 of the Internal Revenue Code.

Pursuant to the exchange of letters between the United States and the Soviet Union, customs duties are not considered to be taxes for purpose of this article.

ARTICLE X: NONDISCRIMINATION

Paragraph 1 of this article provides that a citizen of one Contracting State who is a resident of the other Contracting State shall not be subjected in that other State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which citizens of that other State in the same circumstances are or may be subjected. The determination whether there is more burdensome taxation is to be made by comparing the treatment of individuals who are in comparable positions. Thus, for example, a citizen of the Soviet Union who is a resdient of the United States and who otherwise meets the requirements specified in section 911(a)(2) of the Code under this article would be eligible for the benefits of section 911(a)(2) even though not a citizen of the United States.

Paragraph 2 of this article extends the rule of paragraph 1 by providing that a citizen of one Contracting State who is a resident of the other Contracting State, or a representation established in the other State by a resident of the first State, shall not be subjected in that other State to more burdensome taxes than are generally imposed in that other State on citizens or representations of third States carrying on the same activities. Our existing income tax conventions generally require instead that where a resident of one State maintains a permanent establishment in the other State, the permanent establishment may not be subjected to more burdensome taxes in that other State than are imposed on residents of that State carrying on the same activities. Because Soviet enterprises are taxed by the Soviet Union quite differently than Western business enterprises are taxed by their own countries, however, it was believed that it would be more appropriate to test whether a resident of the United States with a representation in the Soviet Union was subjected to discriminatory taxes by comparing its tax burden with that of representations maintained in the Soviet Union by residents of third countries. This test also applies in testing whether an individual citizen of the United States who is a resident of [35] the Soviet Union is subject to discriminatory taxes (in addition to the test in paragraphs 1 of this article), for the same reasons. However, paragraph 2 does not require a Contracting State to grant to citizens or representations of residents of the other Contracting State any tax benefits which are granted by special agreements to citizens or representations of residents of a third state, for example in a bilateral income tax convention between the Soviet Union and a third state.

Paragraph 3 provides that the taxes which are covered by this article are taxes of any kind imposed at the national, republic or state, or local level. In the exchange of letters, however, it is agreed that customs duties are not to be considered as taxes for purposes of this article.

ARTICLE XI: MUTUAL AGREEMENT

This article provides that when a resident of one Contracting State considers that action of one or both Contracting States has resulted, or will result, in taxation contrary to the provisions of the Convention, such resident may present his case to the competent authority of the State of which he is a resident or citizen. This remedy is in addition to any remedy provided by the national laws of either State. The article contemplates that the competent authorities of the two

States will endeavor to settle by mutual agreement such cases of taxation not in accordance with the proposed Convention as well as any other difficulties or doubts arising as to the interpretation or application of the proposed Convention, such as with respect to the definition of terms not having a common meaning in the two States.

In cases in which the competent authorities reach agreement, taxes will be imposed, and refund or credit of taxes allowed by the Contracting States in accordance with such agreement. This provision permits the issuance of a refund or credit notwithstanding procedural barriers otherwise existing under a Contracting State's law, such as the statute of limitations. This provision will apply only where agreement or partial agreement has been reached between the competent authorities. Similar results are reached under our recent income tax conventions.

ARTICLE XII: NOTIFICATION OF CHANGES IN LAW

This article provides that the competent authority of each State will notify the competent authority of the other State annually of any amendment of the tax legislation referred to in paragraph 1 of Article I (presently existing taxes covered by the Convention), and of the adoption of taxes referred to in paragraph 2 of Article I (taxes in addition to, or in place of, existing taxes), by transmitting the texts of any such amendments or new statutes. In addition, under this article the competent authority of each State will notify the competent authority of the other State of any published material interpreting the Convention, whether in the form of regulations, rulings, or judicial decisions.

ARTICLE XIII: RATIFICATION

This article provides that the Convention shall be subject to ratification, and that the instruments of ratification shall be exchanged as soon as possible. The Convention will enter into force 30 days after the day [36] of the exchange of such instruments. However, the provisions of the Convention will be effective with respect to income derived on or after January 1 of the year following the year in which instruments of ratification are exchanged.

ARTICLE XIV: TERMINATION

Paragraph 1 of this article provides that the Convention will continue in effect indefinitely, but may be terminated by either State at any time after 3 years from the date on which the Convention enters into force. A State seeking to terminate the proposed Convention must give at least 6 months' prior notice through diplomatic channels, in which case such termination will be effective as respects income derived on or after January 1 next following the expiration of the 6-month period.

Paragraph 2 of this article provides that certain portions of the Convention may be separately terminated by either State without terminating the entire Convention. The provisions of paragraph 1(e), (f) or (g) of Article III (Exempt Items of Income), and Article IX (Taxes on Transactions) may be separately terminated by either State at any time after three years from the date on which the Convention enters into force. Such termination would be effective with respect to income derived on or after January 1 of the year following the year in which such notice is given.

[37] DEPARTMENT OF THE TREASURY,
Washington, D.C., December 3, 1975.

HON. JOHN J. SPARKMAN,
Chairman, Senate Foreign Relations Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: During the consideration of the proposed U.S.-U.S.S.R. Tax Convention, some question was raised about the operation of Article VIII, which would apply the convention "only to the taxation of income from activity conducted in a Contracting State in accordance with the laws and regulations in force in such Contracting State."

In our view, the article in its present form has limited significance. It is our understanding that the benefits of the convention would not be denied a taxpayer by a Contracting State unless the activity giving rise to the income in question were itself a violation of a public policy of major concern to that Contracting State and the business activity in question were in fundamental conflict with the law of that State. It is not meant to apply to situations where an activity is only technically in violation of law.

It would not, in our view, be consistent with the spirit and purpose of the convention to deny tax benefits in the U.S.S.R. to a U.S. citizen or business for violation of laws or regulations of a secondary or peripheral nature. Further, the denial of benefits could only properly be applied to that portion of the taxpayer's income attributable to the illegal activity itself.

We do not expect that much use will be made of Article VIII, since benefits under the convention should be denied only, if at all, for serious violations of public policy reflected in law and regulation which are established and proven in accordance with the requirements of the due process of law, and since there is a mutual interest in the smooth functioning of the convention. Were evidence of arbitrary or capricious denials to emerge, we would ask for this to be corrected. Should these corrective efforts be frustrated, we would review the manner in which benefits were being accorded to Soviet interests under the Convention. It would also result in serious consideration of terminating the treaty at the end of its first trial period of three years.

A provision such as Article VIII is not deemed necessary to meet any U.S. purposes and, therefore, in view of the concerns which have been raised, its inclusion in the present agreement would not be taken as a

precedent for the future. At an appropriate occasion when the convention is reviewed for possible amendment an effort will be made to secure elimination of Article VIII.

The Committee may be assured that the Treasury and the Department of State will monitor closely the implementation of this convention including any application of Article VIII, and will keep the Committee fully informed.

Sincerely yours,

CHARLES M. WALKER,
Assistant Secretary for Tax Policy.

[38] DEPARTMENT OF STATE,
Washington, December 3, 1975.

HON. JOHN J. SPARKMAN,
Chairman, Committee on Foreign Relations, U.S. Senate.

DEAR MR. CHAIRMAN: I am writing to urge early and favorable action by the Committee on Foreign Relations on the Tax Convention with the USSR. Implementation of the Convention would be another step toward normal relations with the Soviet Union.

The Department of State endorses the Treasury Department's letter to you dated December 3, 1975. Although we understand the Committee has certain misgivings about Article VIII, in view of the Treasury letter, we hope your Committee will act on the Convention, and that it can be approved by the Senate during the current session.

The Soviet Government has recently reiterated its interest in moving forward with ratification as rapidly as possible, and favorable action at this time would have a positive effect on US-Soviet bilateral relations.

If there is any further assistance which we can provide on this matter, do not hesitate to call on me.

Sincerely,

ROBERT S. INGERSOLL,
Acting Secretary.

TEXT OF RESOLUTION OF RATIFICATION

Resolved, (Two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention between the United States of America and the Union of Soviet Socialist Republics on Matters of Taxation, with Related Letters, signed at Washington on June 20, 1973.

United States-Australia Income Tax Convention

T.D. 6108, 1954-2 C.B. 614

Australian corporation; permanent establishment. An Australian corporation that sells its products on consignment to its wholly owned U.S. subsidiary for resale, at prices the subsidiary determines, to independent retailers and wholesalers does not thereby have a permanent establishment in the U.S. for purposes of the U.S.-Australian Income Tax Convention.

Rev. Rul. 76-322

Advice has been requested whether an Australian corporation that ships goods to the United States on a consignment basis for sale therein is subject to the Federal income tax with respect to such activity under the provisions of the Income Tax Convention between the United States and Australia (the Convention), T.D. 6108, 1954-2 C.B. 614.

P, a foreign corporation organized under the laws of Australia, manufactures products distributed in various countries. *S*, a domestic corporation whose principal place of business is in the United States, is a wholly owned subsidiary of *P*. *P* sells its products at arm's-length prices to *S*, a United States distributor for the products. *S*, on its own behalf, then sells such products (at prices it determines) to independent retailers and wholesalers throughout the United States. In addition, *P* sells its products at arm's-length prices to other unrelated and independent distributors in the United States. These distributors do not constitute permanent establishments of *P* under the Convention.

The agreement between *P* and *S* provides, among other things, that products will be delivered to a carrier at *P*'s plant in Australia, to be forwarded by such carrier for and on behalf of, and at the expense and risk of, *S* to such point or points in the United States as *S* may designate. All responsibility for such products is assumed by *S* which may from time to time and without notice to or consent of *P* move such products to such locations as it desires.

The products are held by *S* on consignment. The title to and ownership of such products is in *P* until purchased by *S* in accordance with the provisions of the agreement. The purchase by *S* from *P* takes place immediately prior to the sale of such products by *S*.

The agreement further provides that *S* is responsible to *P* for damage, destruction, theft, or loss of goods prior to purchase by *S*. *S* bears the cost of insurance of the consigned goods with the loss payable to *P*. Upon request, *S* furnishes *P* with an inventory of all products held on consignment, but it is not liable to account to *P* for the proceeds of sales made by *S*. Also, *S* is under no obligation to purchase the consigned products. *P* has the right to recall any consigned products prior to the time of their purchase by *S*.

P has no employees in the United States and conducts no other business in the United States. *S* sells in its own name to its own customers.

Article III(1) of the Convention provides, in part, that an Australian enterprise shall not be subject to United States tax in respect of its industrial or commercial profits unless it is engaged in trade or business in the United States through a permanent establishment therein.

Article II(1)(o) of the Convention defines the term "permanent establishment," in part, as meaning a branch, agency, management or fixed place of

business. Where an enterprise of one of the Contracting States has a subsidiary corporation that is engaged in trade or business in the other State, whether through a permanent establishment or otherwise, or has an agent in that other State (other than an agent who has and habitually exercises, a general authority to negotiate and conclude contracts on behalf of that enterprise, or regularly fills orders on its behalf from a stock of goods located in that other State), that enterprise shall not, merely by reason thereof, be deemed to have a permanent establishment in that other State.

Under the concepts of the Convention, the absence of a permanent establishment, on the part of an enterprise having business dealings in the country concerned, is based in part upon the premise that such business dealings are handled through a commission agent, broker or other independent agent. A subsidiary corporation will be treated as an independent agent, as distinguished from an agent of the parent, under similar circumstances. The subsidiary corporation's presence in the country concerned, where it is engaged in trade or business, is by itself no basis to hold that the parent corporation has a permanent establishment in such country, unless the subsidiary has and habitually exercises a general authority to contract for it's parent, or as an agent of the parent regularly fills orders of goods on behalf of the parent from a stock of the parent's goods located in such country.

Under the agreement in the instant case, neither a limited agency nor a general agency is established. The relationship between *P* and *S* is that of seller and purchaser, since the power that *S* has in determining when title to the consigned goods passes from *P* is exercisable only as a purchaser. *See* Rev. Rul. 63-113, 1963-1 C.B. 410, which holds under substantially similar circumstances, that the relationship between a foreign corporation and an unrelated domestic consignee was that of seller and purchaser. Further, since *S* is not considered *P*'s agent, although *P* has a "stock of goods" in the United States, *P* has no employee or agent in the United States that could fill orders from such stock of goods.

Accordingly, *P* does not have a permanent establishment in the United States within the meaning of the Convention. Therefore, the income derived by *P* from transactions with *S*, it's subsidiary, in accordance with the terms of the agreement discussed herein, is not subject to Federal income tax.

United States-Belgium Income Tax Convention

1973-1 C.B. 619; Section 504.108.
(Also Part I, Sections 881, 894, 4940, 4948; 26 CFR 1.881-2, 1.894-1, 53.4940-1, 53.4948-1.)

Belgian private foundation; investment income. A Belgian private foundation, whose only business activities in the U.S. are investments from which it derives interest income, is not exempt from the excise tax on gross investment income imposed by section 4948(a) of the Code.

Rev. Rul. 76-330

Advice has been requested whether, under the circumstances described below, a Belgian private foundation is subject to the excise tax imposed by section 4948(a) of the Internal Revenue Code of 1954.

M is a private foundation resident in Belgium that receives substantially all of its support, other than gross investment income, from sources outside the United States. *M* does not have a permanent establishment in the United States and, aside from investment activities, is not engaged in business in the United States. During its 1975 taxable year, *M* derived 20*x* dollars of gross investment income consisting of interest from sources within the United States.

Section 4948(a) of the Code provides, in part, that there is imposed for each taxable year on the gross investment income (within the meaning of section 4940(c)(2)) derived from sources within the United States (within the meaning of section 861) by every foreign organization that is a private foundation for the taxable year a tax equal to 4 percent of such income.

Section 4940(c)(2) of the Code provides, in part, with exceptions not relevant here, that the term "gross investment income" includes the gross amount of income from interest.

Section 53.4948-1(a)(3) of the Foundation Excise Tax Regulations provides that whenever there exists a tax treaty between the United States and a foreign country, and a foreign private foundation subject to section 4948(a) of the Code is a resident of such country or is otherwise entitled to the benefits of such treaty (whether or not such benefits are available to all residents), if the treaty provides that any item or items (or all items with respect to an organization exempt from income taxation) of gross investment income (within the meaning of section 4940(c)(2)) shall be exempt from income tax, such item or items shall not be taken into account by such foundation in computing the tax to be imposed under section 4948(a) for any taxable year for which the treaty is effective.

Section 881(a)(1) of the Code imposes a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as interest to the extent such amount is not effectively connected with the conduct of a trade or business within the United States.

Section 894(a) of the Code provides that income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under subtitle A, Chapter 1 of the Code.

Article 11 of the United States-Belgium Income Tax Convention, 1973-1 C.B. 619, (The Belgian Convention), provides, in part, that interest derived from sources within the United States by a resident of Belgium

may be taxed by the United States at a rate not exceeding 15 percent.

Article 9(3) of the Treaty of Friendship, Establishment and Navigation with the Kingdom of Belgium, February 21, 1961, T.I.A.S. No. 5432 (effective October 3, 1963) (Belgian F.E.N. Treaty) provides, in part, that companies of Belgium that are not engaged in trade or other gainful pursuit within the territories of the United States, shall not be subject, within the territories of the United States, to the payment of taxes, fees, or charges imposed upon or applied to income, capital, transactions, activities, or any other object, or to requirements with respect to the levy and collection thereof, more burdensome than those borne by companies of any third country.

Article 9(5) of the Belgian F.E.N. Treaty provides, in part, that the provisions of Article 9 shall not obligate the United States to extend to Belgian companies tax advantages accorded to companies of any third country by virtue of agreements for the avoidance of double taxation.

Income tax conventions (agreements for the avoidance of double taxation) with countries *X* and *Y* exempt interest income of corporations resident in *X* and *Y* from income taxation.

The specific question presented in the instant case is whether either (1) the Belgian Convention, or (2) the Belgian F.E.N. Treaty, requires that interest income of a Belgian private foundation be exempt from tax. If so, under section 53.4948-1(a)(3) of the regulations, these items would not be taken into account by the private foundation in computing the tax imposed by section 4948(a) of the Code.

As described above, the Belgian Convention reduces the tax rate on interest derived by a Belgian corporation from sources in the United States from 30 percent, as specified in section 881(a)(1) of the Code, to 15 percent. This reduction of the applicable rate is not an exemption of such items from tax.

Similarly, the Belgian F.E.N. Treaty does not exempt interest income of a Belgian corporation from tax since the income tax conventions with countries *X* and *Y*, which, exempt such income of corporations resident in *X* and *Y*, are agreements for the avoidance of double taxation.

Accordingly, because neither the Belgian Convention nor the Belgian F.E.N. Treaty exempt *M*'s investment income from income taxation, section 53.4948-1(a)(3) of the regulations does not operate to exempt such income from the tax imposed by section 4948(a) of the Code.

United States-Republic of Chile Income Tax Agreement [1]

Agreement effected by exchange of notes Signed at Santiago December 29 and 31, 1975; Entered into force January 30, 1976; Effective January 1, 1975.

The American Ambassador to the Chilean Minister of Foreign Relations

EMBASSY OF THE UNITED STATES OF AMERICA
SANTIAGO, CHILE

No. 385

DECEMBER 29, 1975

EXCELLENCY:

I have the honor to refer to recent conversations between representatives of the Government of the United States of America and representatives of the Government of the Republic of Chile relating to the possibility of concluding an agreement between the two Governments with a view to granting, on a reciprocal basis, relief from double taxation on earnings derived from the operation of aircraft. The Government of the United States of America agrees as follows:

1. The Government of the United States of America, in accordance with Sections 872(B) and 883(A) of its Internal Revenue Code of 1954, [2] shall, on the basis of equivalent exemptions granted by the Government of the Republic of Chile to citizens of the United States of America and to corporations organized in the United States of America, exclude from gross income and exempt from income tax all earnings derived

A. By a corporation organized in the Republic of Chile, or

B. By an individual who is

(i) A citizen of the Republic of Chile and

(ii) A nonresident alien as to the United States of America from the operation of aircraft registered under the laws of the Republic of Chile, including income from the incidental lease of aircraft or containers.

2. This agreement shall be applicable with respect to taxable years beginning on or after the first day of January, 1975.

3. Either of the two Governments may terminate this agreement by giving the other Government six months' prior notice of termination in writing and, in such event, the agreement shall cease to be effective for the taxable years beginning on or after the first day of January next following the expiration of the six-month period.

The Government of the United States of America will consider this Note, together with Your Excellency's Note of reply confirming that the Government of the Republic of Chile agrees to terms corresponding to those outlined above, as constituting the agreement between the two Governments. The present agreement shall enter into force upon receipt from the Government of Chile of written notification that its required constitutional procedures have been fulfilled, provided this is completed by January 31, 1976, [3]

Accept, Excellency, the assurances

[1] The official text of the agreement is contained in the pamphlet of the Treaties and Other International Act Series (TIAS) and is designated TIAS 8252.

[2] 68A Stat. 280, 283; 26 U.S.C. §§ 872(b), 883(a).

[3] January 30, 1976.

of my highest and most distinguished consideration.

DAVID H. POPPER

His Excellency
Vice Admiral
PATRICIO CARVAJAL PRADO
Minister of Foreign Relations
Santiago, Chile

The Chilean Minister of Foreign Relations to the American Ambassador

* * * * *

REPUBLIC OF CHILE
MINISTRY OF FOREIGN RELATIONS

No. 23745

SANTIAGO, *December 31, 1975*

MR. AMBASSADOR:

I have the honor to acknowledge recept of Your Excellency's note No. 385 dated December 29, 1975, referring to recent conversations between representatives of the Government of the Republic of Chile and representatives of the Government of the United States of America concerning the possibility of concluding an agreement between the two Governments with a view to granting, on a reciprocal basis, relief from double taxation on income derived from the operation of aircraft. It has been noted that the Government of the United States of America agrees with certain terms as set forth in the aforesaid note. For its part, the Government of the Republic of Chile agrees as follows:

1. The Government of the Republic of Chile shall, on the basis of equivalent exemptions granted by the Government of the United States of America to citizens of the Republic of Chile and to corporations organized in the Republic of Chile, exclude from gross income tax and exempt from income tax all earnings derived.

A. By a corporation organized in the United States of America, or

B. By an individual who is

(i) A citizen of the United States of America and

(ii) A nonresident alien in the Republic of Chile

from the operation of aircraft registered under the laws of the United States of America, including income from the incidental lease of aircraft or containers.

2. This agreement shall be applicable with respect to taxable years beginning on or after the first day of January 1975.

3. Either of the two Governments may terminate this agreement by giving the other Government six months' prior notice in writing and, in such event, the agreement shall cease to be effective for the taxable years beginning on or after the first day of January following the expiration of the six-month period.

The Government of the Republic of Chile consider that the abovementioned note from Your Excellency, together with this note in reply, shall constitute the agreement between the two Governments. The agreement shall enter into force upon receipt from the Government of Chile by the Government of the United States of America of written notification that the necessary constitutional procedures have been fulfilled, provided this is completed by January 31, 1976.

I avail myself of this opportunity to renew to Your Excellency the assurance of my highest and most distinguished consideration.

P. CARVAJAL

PATRICIO CARVAJAL PRADO
Minister of Foreign Relations

His Excellency
DAVID H. POPPER,
Ambassador of the
United States of America,
Santiago.

United States—Federal Republic of Germany Income Tax Convention

1955-1 C.B. 635; 1966-1 C.B. 360. (Also Part I, Sections 316, 871, 1441, 7701; 1.316-1, 1.871-1, 1.441-6, 301. 7701-2).

German residents; distributions from U.S. partnership taxed as a corporation. A domestic limited partnership taxable as a corporation for U.S. tax purposes is a corporation for purposes of the U.S.—Federal Republic of Germany Income Tax Convention and distributions from current and accumulated earnings and profits to the German resident limited partners, who are nonresident aliens of the U.S. not engaged in a trade or business in the U.S., are dividends under the Convention taxable at the reduced rate of 15 percent.

Rev. Rul. 76-435

Advice has been requested as to the Federal income tax treatment of distributions made under the circumstances described below.

X company was formed under the uniform limited partnership laws of State *Y*. *P*, a domestic corporation, is the sole general partner of *X* and manages *X*'s business activities. *A* and *B*, limited partners of *X* who hold a majority interest in *X*, are German residents and nonresident aliens of the United States. *A* and *B* own all of the outstanding capital stock of *P*. *A* and *B*, as individuals, do not engage in any trade or business within the United States. *X* manufactures and sells machinery in the United States.

X, because of the preponderance of corporate characteristics, is classified as an association taxable as a corporation for Federal income tax purposes. During the current taxable year, *X* made certain distributions to *A* and *B* that for Federal income tax purposes are treated as distributions out of *X*'s current earnings.

The specific questions are: (1) whether *X* is considered to be a corporation under the United States—Federal Republic of Germany Income Tax Convention (the Convention), 1955-1 C.B. 635, as amended by Protocol, 1966-1 C.B. 360; and, (2) whether the distributions made by *X* to *A* and *B* are taxable to such individuals at the reduced rate for the taxation of dividends under the Convention.

Article II(1)(e) of the Convention defines the term "United States cor-

poration" as a corporation created or organized under the laws of the United States or of any state or territory of the United States.

Article II(2) of the Convention provides that any term not otherwise defined shall, unless the context otherwise requires, have the meaning that the term has under the laws of the country applying the Convention's provisions.

The term "corporation" used in the definition of the term United States corporation is not itself defined in the Convention. Thus, in interpreting the Convention, the term corporation will have the meaning that the term has under the laws of the United States.

Section 7701(a)(3) of the Internal Revenue Code of 1954 provides that the term corporation includes associations, joint-stock companies, and insurance companies.

In the case of *Burk-Waggoner Oil Assn. v. Hopkins,* 269 U.S. 110 (1925), V-1 C.B. 147 (1926), the Supreme Court of the United States stated that although Congress cannot convert into a corporation an organization that by law of its state is a partnership, nothing in the Constitution precludes Congress from taxing as a corporation an association that, although unincorporated, transacts its business as if it were incorporated.

Accordingly, an association taxable as a corporation for Federal income tax purposes is a United States corporation as that term is used in Article II(1)(e) of the Convention. Thus, *X* is considered to be a corporation under the Convention.

The term "dividend" is not defined in the Convention with respect to distributions by a United States corporation. Thus, under the provisions of Article II(2) of the Convention the term dividend will have the meaning that the term has under the laws of the United States.

Section 316(a) of the Code provides, in part, that the term dividend means any distribution of property made by a corporation to its shareholders out of the corporation's current or accumulated earnings and profits.

Section 1.864-3(a) of the Income Tax Regulations provides, with exceptions not relevant here, that in the case of a nonresident alien individual who at no time during the taxable year engaged in a trade or business in the United States, no income for the taxable year shall be treated as effectively connected with the conduct of a trade or business in the United States.

Section 871(a)(1)(A) of the Code provides, in part, that dividends received from sources within the United States that are not effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual shall be taxed at a rate of 30 percent.

Section 1441(a) of the Code provides, in part, that all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any of the items of income specified in section 1441(b) of any nonresident alien individual or of any foreign partnership shall deduct and withhold from such items a tax equal to 30 percent thereof.

Section 1441(b) of the Code provides, in part, that the items of income referred to in section 1441(a) include dividends.

Section 1.1441-6(a) of the regulations provides, in part, that the tax rate of 30 percent shall be reduced as may be provided by a treaty with any country.

Article VI(1) of the Convention provides that the United States tax on dividends received by a natural person resident in the Federal Republic or by a German company from a United States corporation shall not exceed 15 percent of the gross amount of the dividends.

In the case of *Smith v. Commissioner,* 69 F.2d 911 (3rd Cir. 1934), *cert. denied,* 293 U.S. 561 (1934), the United States Court of Appeals for the Third Circuit held that a distribution by an association taxable as a corporation from its accumulated earnings and profits was taxable to the owners as a dividend.

The definition of the term dividend set forth in section 316 of the Code shall be applied in the instant case. *See* Article II(2) of the Convention.

Accordingly, the distributions paid by *X* to *A* and *B* are taxable as dividends to the extent they are paid out of current and accumulated earnings and profits at the reduced rate of 15 percent under Article VI of the Convention and are subject to withholding at such rate pursuant to section 1.1441-6(a) of the regulations.

United States-Japan Income Tax Convention

1973-1 C.B. 630
(Also Section 894; 1.894-1.)

Japan; fellowship grant at research institute. Amounts paid to a citizen of Japan, visiting as a scientist from a Japanese university to do research work at a research institute in the U.S. for a year, as fellowship grants from a charitable institution are exempt from Federal income tax under Article 20 of the U.S.-Japan In-

Rev. Rul. 76-567

Advice has been requested whether, under the circumstances described below, amounts paid to a citizen of Japan for doing research within the United States are exempt from Federal income tax under Article 20 of the United States-Japan Income Tax Convention (the Convention), TIAS 7365, 1973-1 C.B. 630.

A, a citizen of Japan, was a visiting research scientist from a Japanese university. *A* was doing research work at *X* Research Institute (the Institute). *A* came to the Institute on January 1, 1976, and at that date was a resident of Japan. *A* returned to Japan at the completion of the research in December 1976. *A* received a fellowship grant of $16,000 from a charitable organization in connection with such research.

Section 894(a) of the Internal Revenue Code of 1954 provides that income of any kind, to the extent re-

quired by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

Article 20(1)(a)(iii) of the Convention provides, in part, that an individual who is a resident of Japan at the beginning of a visit to the United States and who is temporarily present in the United States for the primary purpose of studying or doing research as a recipient of a grant, allowance, or an award from a governmental, religious, charitable, scientific, literary, or educational institution shall be exempt from Federal income tax with respect to the amounts described in Article 20(1)(b) for a period not exceeding 5 taxable years from the date of the individual's arrival in the United States.

Article 20(1)(b) of the Convention provides, in part, that pursuant to Article 20(1)(a) the following amounts shall be exempt from Federal income tax: (i) gifts from abroad for the purpose of maintenance, education, study, research, or training; (ii) the grant, allowance, or award; and (iii) income for personal services performed in the United States in an aggregate amount not in excess of $2,000 for any taxable year.

In the instant case, *A*, a citizen and a resident of Japan at the time *A* came to the United States, visited the United States for the primary purpose of doing research at the Institute. The fellowship grant of $16,000 received by *A* is a grant, allowance, or award from a charitable institution under Article 20(1)(a)(iii) of the Convention.

Accordingly, the amounts paid to *A* for doing research at the Institute are exempt from Federal income tax under Article 20 of the Convention.

United States-Netherlands Income Tax Convention

T.D. 5778, 1950-1 C.B. 92; 1967-2 C.B. 472

Netherlands; operation of ships; containers. Income of shipping companies from certain ancillary activities connected with use of the container method of ocean transportation for which no special charge is made is exempt from tax as income from the "operation of ships" under Article VI(1) of the U.S.-Netherlands Income Tax Convention and the Supplementary Convention.

Rev. Rul. 76-568

Advice has been requested whether the United States will grant a reciprocal tax exemption to those Netherlands shipping enterprises covered under article VI(1) of the United States-Netherlands Income Tax Convention (the Convention), T.D. 5778, 1950-1 C.B. 92 and the Supplementary Convention, 1967-2 C.B. 472, that do not impose a special charge on the customer for the ancillary activities described below.

Article VI(1) of the Convention and the Supplementary Convention provides, in part, that income that an enterprise of one of the Contracting States derives from the operation of ships or aircraft registered in that State shall be taxable only in the State in which such ships or aircraft are registered.

Under the authority granted by Article XXIV(3) of the Convention the Competent Authority of the Internal Revenue Service and the Netherlands Director-General for Fiscal Affairs have agreed pursuant to an exchange of letters to interpret the phrase "operation of ships" as that phrase is used in Article VI(1) of the Convention and the Supplementary Convention in the folowing manner:

In view of the fact that shipping companies are utilizing the "container" method of ocean transportation, certain ancillary activities connected with container transportation would be included within the provisions applicable to the operation of ships in international traffic.

The specific activities of the shipping company to be included are the following:

1. Providing the containers and special undercarriages for transportation to the port of departure and on board the ship during the ocean transportation;

2. Transferring the containers from the undercarriages or from railway carriages on board the ship;

3. Transportation on board the ship;

4. Unloading the containers on special undercarriages or railway carriages in the port of destination;

5. Providing the containers and special undercarriages for transportation from the port of destination to the customer.

Income from the above activities will be treated as income from the "operation of ships", as that term is used in Article VI(1) of the Convention and the Supplementary Convention, provided that no special charge is imposed on the customer for the ancillary activities mentioned in items 1 or 5 above.

Accordingly, the United States will grant a reciprocal tax exemption to those Netherlands shipping enterprises covered under the Convention and the Supplementary Convention that do not impose a special charge on the customer for ancillary activities described above.

United States-Romania Income Tax Convention [1]

Convention signed at Washington December 4, 1973;

Ratification advised by the Senate of the United States of America November 18, 1975;

Ratified by the President of the United States of America December 15, 1975;

Ratified by Romania December 23, 1974;

Ratifications exchanged at Bucharest January 26, 1976;

Proclaimed by the President of the

[1] The official text of the convention is contained in the pamphlet of the Treaties and Other International Act Series (TIAS) and is designated TIAS 8228. Pertinent excerpts from Senate Executive Report No. 94-15, page 502; Treasury Department Technical Explanation, page 504; Senate Executive B is not published.

United States of America February 25, 1976;

Entered into force February 26, 1976.

BY THE PRESIDENT OF THE UNITED STATES OF AMERICA

A PROCLAMATION

CONSIDERING THAT:

The Convention between the United States of America and the Socialist Republic of Romania with Respect to Taxes on Income was signed at Washington on December 4, 1973, the text of which Convention, in the English and Romanian languages, is hereto annexed;

The Senate of the United States of America by its resolution of November 18, 1975, two-thirds of the Senators present concurring therein, gave its advice and consent to ratification of the Convention;

The Convention was ratified by the President of the United States of America on December 15, 1975, in pursuance of the advice and consent of the Senate, and was ratified on the part of the Socialist Republic of Romania on December 23, 1974;

It is provided in Article 27 of the Convention that the Convention shall enter into force one month after the date of the exchange of instruments of ratification, with effectiveness with respect to income of calendar years or taxable years beginning on or after January 1, 1974;

The instruments of ratification of the Convention were exchanged at Bucharest on January 26, 1976, and accordingly the Convention enters into force on February 26, 1976, effective January 1, 1974;

NOW, THEREFORE, I, Gerald R. Ford, President of the United States of America, proclaim and make public the Convention, to the end that it shall be observed and fulfilled with good faith on and after February 26, 1976, by the United States of America and by the citizens of the United States of America and all other persons subject to the jurisdiction thereof.

IN TESTIMONY WHEREOF, I have signed this proclamation and caused the Seal of the United States of America to be affixed.

DONE at the city of Washington this twenty-fifth day of February in the year of our Lord one thousand nine hundred seventy-six and of the independence of the United States of America the two hundredth.

[S E A L]

Gerald R. Ford

By the President
Henry S. Kissinger
Secretary of State

CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE SOCIALIST REPUBLIC OF ROMANIA WITH RESPECT TO TAXES ON INCOME

The Government of the United States of America and the Government of the Socialist Republic of Romania, desiring to conclude a convention for the avoidance of double taxation of income and property and the prevention of fiscal evasion, have agreed as follows:

ARTICLE 1

TAXES COVERED

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

(a) In the case of Romania, the income taxes imposed under Romanian law, in particular the income taxes imposed on:

(i) wages, salaries, fees, copyrights, and income from any other source received by individuals;

(ii) profits of mixed companies;

(iii) enterprises other than mixed companies or state enterprises;

(iv) agricultural activities;

(v) rentals; and

(vi) nonresidents.

(b) In the case of the United States, the Federal income taxes imposed by the Internal Revenue Code (other than social insurance taxes imposed by chapters 2 and 21).

(2) This Convention shall also apply to taxes substantially similar to those covered by paragraph (1) which are imposed in addition to, or in place of, existing taxes after the date of signature of this Convention.

(3) For purposes of paragraph (5) of Article 7 (Business Profits), this Convention shall also apply to taxes other than income taxes imposed at the national level of a Contracting State on insurance and reinsurance premiums paid to a resident of the other Contracting State. For the purpose of Article 22 (Nondiscrimination), this Convention shall also apply to taxes of every kind imposed at the national, state, or local level.

(4) The competent authorities of the Contracting States shall notify each other of any amendments of the tax laws referred to in paragraph (1) and of the adoption of any taxes referred to in paragraph (2) by transmitting the texts of any amendments on new statutes at least once a year.

ARTICLE 2

GENERAL DEFINITIONS

(1) In this Convention:

(a) (i) The term "Romania" means the Socialist Republic of Romania; and

(ii) When used in a geographical sense the term "Romania" also includes:

(A) The territorial sea thereof, and

(B) The seabed and subsoil of the submarine areas adjacent to the coast thereof, but beyond the territorial sea, over which Romania exercises sovereign rights, in accordance with international law, for the purpose of exploration for and exploitation of the natural resources of such areas, but only to the extent that the person, property, or activity to which this Convention is being applied in connected with such exploration or exploitation.

(b) (i) The term "United States" means the United States of America; and

(ii) When used in a geographical

sense, the term "United States" means the states thereof and the District of Columbia. Such term also includes:

(A) The territorial sea thereof, and

(B) The seabed and subsoil of the submarine areas adjacent to the coast thereof, but beyond the territorial sea, over which the United States exercises sovereign rights, in accordance with international law, for the purpose of exploration for and exploitation of the natural resources of such areas, but only to the extent that the person, property, or activity to which the Convention is being applied is connected with such exploration or exploitation.

(c) The term "Contracting State" means the United States or Romania, as the context requires.

(d) The term "person" includes an individual, a partnership, a corporation, an estate, or a trust.

(e)(i) The term "Romanian corporation" means any juridical person, including a mixed corporation which is incorporated and organized under Romanian law or any other legal entity created under Romanian law which is treated as a juridical person according to Romanian taxation laws.

(ii) The term "United States corporation" means a corporation, or any entity treated as a corporation for United States tax purposes, which is created or organized under the laws of the United States or any state thereof or the District of Columbia; and

(f) The term "competent authority" means:

(i) In the case of Romania, the Minister of Finance or his delegate, and

(ii) In the case of the United States, the Secretary of the Treasury or his delegate.

(g) The term "tax" means tax imposed by the United States or Romania, whichever is applicable, to which this Convention applies by virtue of Article 1 (Taxes Covered).

(h) The term "international traffic" means any voyage of a ship or aircraft operated by a resident of one of the Contracting States except where such voyage is confined solely to places within a Contracting State.

(2) Any other term used in this Convention and not defined in this Convention shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined. Notwithstanding the preceding sentence, if the meaning of such a term under the laws of one of the Contracting States is different from the meaning of the term under the laws of the other Contracting State, or if the meaning of such a term is not readily determinable under the laws of one of the Contracting States, the competent authorities of the Contracting States may, in order to prevent double taxation or to further any other purpose of this Convention, establish a common meaning of the term for purposes of this Convention.

ARTICLE 3

FISCAL RESIDENCE

(1) In this Convention:

(a) The term "resident of Romania" means:

(i) A Romanian corporation (as defined in paragraph (1)(e)(i) of Article 2 (General Definitions), or

(ii) Any other person resident in Romania, but in the case of a partnership, estate, or trust only to the extent that the income derived by such person is subject to United States tax.

(b) The term "resident of the United States" means:

(i) A United States corporation (as defined in paragraph (1)(e)(ii) of Article 2 (General Definitions)), or

(ii) Any other person resident in the United States, but in the case of a partnership, estate, or trust only to the extent that the income derived by such person is subject to United States tax.

(2) Where by reason of the provisions of paragraph (1) an individual is a resident of both Contracting States:

(a) He shall be deemed to be a resident of that Contracting State in which he maintains his permanent home. If he has a permanent home in both Contracting States or in neither of the Contracting States, he shall be deemed to be a resident of that Contracting State with which his personal and economic relations are closest (center of vital interests);

(b) If the Contracting State in which he has his center of vital interests cannot be determined, he shall be deemed to be a resident of that Contracting State in which he has a habitual abode;

(c) If he has a habitual abode in both Contracting States or in neither of the Contracting States, he shall be deemed to be a resident of the Contracting State of which he is a citizen; and

(d) If he is a citizen of both Contracting States or of neither Contracting State, the competent authorities of the Contracting States shall settle the question by mutual agreement.

ARTICLE 4

GENERAL RULES OF TAXATION

(1) A resident of one of the Contracting States may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income, subject to any limitations set forth in this Convention.

(2) The provisions of this Convention shall not be construed to restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded—

(a) By the laws of one of the Contracting States in the determination of the tax imposed by that Contracting State, or

(b) By any other agreement between the Contracting States.

(3) Notwithstanding any provisions of this Convention except paragraph (4), a Contracting State may tax its citizens or residents (as determined under Article 3 (Fiscal Residence)) as if this Convention had not come into effect.

(4) The provisions of paragraph (3) shall not affect:

(a) The benefits conferred by a

Contracting State under Articles 17 (Social Security Payments), 21 (Relief from Double Taxation), 22 (Nondiscrimination), and 23 (Mutual Agreement Procedure); and

(b) The benefits conferred by a Contracting State under Articles 18 (Governmental Functions), 19 (Teachers), 20 (Students and Trainees), and 25 (Members of Diplomatic Missions and Consular Offices) upon individuals who are neither citizens of, nor have immigrant status in, that Contracting State.

(5) The competent authorities of the two Contracting States may prescribe regulations necessary to carry out the provisions of this Convention.

Article 5

PERMANENT ESTABLISHMENT

(1) For the purpose of this Convention, the term "permanent establishment" means a fixed place of business through which the business of a resident of one of the Contracting States is wholly or partly carried on.

(2) The term "permanent establishment" includes but is not limited to:

(a) A branch;

(b) An office;

(c) A factory;

(d) A workshop;

(e) A warehouse;

(f) A mine, quarry, or other place of extraction of natural resources; and

(g) A construction or installation project which exists for more than 12 months.

(3) Notwithstanding paragraphs (1) and (2), a permanent establishment shall not include a fixed place of business used only for one or more of the following:

(a) The use of facilities for the purpose of storage, display, or delivery pursuant to a sales contract, of goods or merchandise belonging to the resident;

(b) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of processing by another person;

(c) The maintenance of a fixed place of business for the purpose of purchasing of goods or merchandise, or for collecting information, for the resident;

(d) The maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the resident; or

(e) The maintenance of a construction or installation project which does not exist for more than 12 months.

(4) A person acting in one of the Contracting States on behalf of a resident of the other Contracting State, other than an agent of an independent status to whom paragraph (5) applies, shall be deemed to give rise to a permanent establishment in the first-mentioned Contracting State if such person has, and habitually exercises in the first-mentioned Contracting State, an authority to conclude contracts in the name of that resident, unless the exercise of such authority is limited to the purchase of goods or merchandise for that resident.

(5) A resident of one of the Contracting States shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident engages in industrial or commercial activity in that other Contracting State through a broker, general commission agent, or any other agent of an independent status, where such broker or agent is acting in the ordinary course of his business.

(6) A resident of one of the Contracting States shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident sells at the termination of a trade fair or convention in such other Contracting State goods or merchandise which such resident displayed at such trade fair or convention.

(7) In determining whether a resident of one Contracting State has a permanent establishment in the other Contracting State there shall not be taken into account the fact that such resident may be related to either a resident of the other Contracting State or to any other person who engages in that other Contracting State.

(8) The principles set forth in paragraphs (1) through (7) shall also be applied in determining whether there is a permanent establishment in a State other than one of the Contracting States or whether a person other than a resident of one of the Contracting States has a permanent establishment in one of the Contracting States.

Article 6

INCOME FROM IMMOVABLE PROPERTY

(1) Income from immovable property, including royalties and other payments in respect of the exploitation of natural resources and gains derived from the sale, exchange, or other disposition of such property or of the right giving rise to such royalties or other payments, may be taxed by the Contracting State in which such immovable property or natural resources are situated. For purposes of this Convention, interests on indebtedness secured by immovable property or secured by a right giving rise to royalties or other payments in respect of the exploitation of natural resources shall not be regarded as income from immovable property.

(2) Paragraph (1) shall apply to income derived from the usufruct, direct use, letting, or use in any other form of immovable property.

Article 7

BUSINESS PROFITS

(1) Industrial or commercial profits of a resident of one of the Contracting States shall be exempt from tax by the other Contracting State unless the resident has a permanent establishment in that other Contracting State. If the resident has a permanent establishment in that other Contracting State, tax may be imposed by that other Contracting State on the industrial or commercial profits of the resi-

dent but only on so much of them as are attributable to the permanent establishment.

(2) Where a resident of one of the Contracting States has a permanent establishment in the other Contracting State, there shall in each Contracting State be attributed to the permanent establishment the industrial or commercial profits which would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the resident of which it is a permanent establishment.

(3) In the determination of the industrial or commercial profits of a permanent establishment, there shall be allowed as deductions expenses which are reasonably connected with such profits, including executive and general administrative expenses, whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere.

(4) No profits shall be attributed to a permanent establishment of a resident of one of the Contracting States in the other Contracting State merely by reason of the purchase of goods or merchandise by that permanent establishment, or by the resident of which it is a permanent establishment, for the account of that resident.

(5) Insurance or reinsurance premiums derived from sources within one Contracting State by a resident of the other Contracting State shall not be subject to income tax or any other tax in the first Contracting State unless such income is effectively connected with a permanent establishment of the resident in that Contracting State.

(6) The term "industrial or commercial profits" includes, but is not limited to, income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, and the rental of tangible personal (movable) property. Such term does not include the performance of personal services by an individual either as an employee or in an independent capacity. Such term also includes any other income effectively connected with a permanent establishment which the recipient, being a resident of one of the Contracting States, has in the other Contracting State.

(7) To determine whether property or rights are effectively connected with a permanent establishment, the factors taken into account shall include whether the rights or property are used in or held for use in carrying on an activity giving rise to industrial or commercial profits through such permanent establishment and whether the activities carried on through such permanent establishment were a material factor in the realization of the income derived from such property or rights. For this purpose, due regard shall be given to whether or not such property or rights or such income were accounted for through such permanent establishment.

(8) Where industrial or commercial profits include items of income which are dealt with separately in other articles of this Convention, the provisions of those articles shall, except as otherwise provided therein, supersede the provisions of this article.

ARTICLE 8

SHIPPING AND AIR TRANSPORT

(1) Notwithstanding Article 7 (Business Profits) and Article 13 (Capital Gains), income derived by a resident of one of the Contracting States from the operation in international traffic of ships or aircraft registered in that Contracting State and gains derived from the sale, exchange, or other disposition of ships or aircraft used in international traffic and which are registered in that Contracting State shall be exempt from taxation by the other Contracting State.

(2) For purposes of this article, income derived from the operation in international traffic of ships or aircraft includes—

(a) Income derived from the rental of ships or aircraft operated in international traffic if such rental income is incidental to other income described in paragraph (1); and

(b) Income derived from the use, maintenance, and lease of containers and other related equipment in connection with the operation in international traffic of ships or aircraft by the resident described in paragraph (1).

ARTICLE 9

RELATED PERSONS

(1) Where a person subject to the taxing jurisdiction of one of the Contracting States and any other person are related and where such related persons make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, any income, deductions, credits, or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income (or loss) of, or the tax payable by, one of such persons, may be taken into account in computing the amount of the income subject to tax and the taxes payable by such person.

(2) Where a redetermination has been made by one Contracting State to the income of one of its residents in accordance with paragraph (1), then the other Contracting State shall, if it agrees with such redetermination, make a corresponding adjustment to the income of a person in such other Contracting State related to such resident. In the event the other Contracting State disagrees with such redetermination, the two Contracting States shall endeavor to reach agreement in accordance with the mutual agreement procedure in paragraph (2)(b) of Article 23 (Mutual Agreement Procedure).

(3) For purposes of this Convention, a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both. For this purpose, the term "control" includes any kind of control, whether or

not legally enforceable, and however exercised or exercisable.

ARTICLE 10

DIVIDENDS

(1) Dividends paid by a corporation of one of the Contracting States to a resident of the other Contracting State may be taxed by both Contracting States.

(2) The rate of tax imposed by the first-mentioned Contracting State on such dividends shall not exceed 10 percent of the gross amount of the dividend.

(3) Paragraph (2) shall not apply if the recipient of the dividends, being a resident of one of the Contracting States, has a permanent establishment in the other Contracting State and the shares with respect to which the dividends are paid are effectively connected with such permanent establishment. In such a case, paragraph (6) of Article 7 (Business Profits) shall apply.

ARTICLE 11

INTEREST

(1) Interest derived by a resident of one of the Contracting States from sources within the other Contracting State may be taxed by both Contracting States.

(2) Interest derived by a resident of one of the Contracting States from sources within the other Contracting State shall not be taxed by the other Contracting State at a rate in excess of 10 percent of the gross amount of such interest.

(3) Notwithstanding paragraphs (1) and (2), interest beneficially derived by (a) one of the Contracting States, or by an instrumentality of that Contracting State, not subject to tax by that Contracting State on its income, or (b) a resident of such Contracting State with respect to indebtedness guaranteed, insured, or indirectly financed by that Contracting State or instrumentality thereof, shall be exempt from tax by the other Contracting State.

(4) Paragraph (2) shall not apply if the recipient of the interest, being a resident of one of the Contracting States, has a permanent establishment in the other Contracting State and the indebtedness giving rise to the interest is effectively connected with such permanent establishment. In such a case, paragraph (6) of Article 7 (Business Profits) shall apply.

(5) Where an amount is paid to a related person which would be treated as interest but for the fact that it exceeds an amount which would have been paid to an unrelated person, the provisions of this article shall apply only to so much of the amount as would have been paid to an unrelated person. In such a case, the excess amount may be taxed by each Contracting State according to its own law, including the provisions of this Convention where applicable.

(6) The term "interest" as used in this Convention means income from bonds, Government securities, notes, or other evidences of indebtedness, whether or not secured and whether or not carrying a right to participate in profits, and debt-claims of every kind, as well as all other income which, under the taxation law of the Contracting State in which the income has its source, is assimilated to income from money lent.

(7) Interest shall be treated as derived from sources within a Contracting State only if paid by such Contracting State, a political subdivision or a local authority thereof, or by a resident of that Contracting State. Notwithstanding the preceding sentence—

(a) If the person paying the interest (whether or not such person is a resident of one of the Contracting States) has a permanent establishment in one of the Contracting States in connection with which the indebtedness on which the interest is paid was incurred and such interest is borne by such permanent establishment, or

(b) If the person paying the interest is a resident of one of the Contracting States and has a permanent establishment in a State other than a Contracting State in connection with which the indebtedness on which the interest is paid was incurred and such interest is paid to a resident of the other Contracting State, and such interest is borne by such permanent establishment,

such interest shall be deemed to be from sources within the State in which the permanent establishment is situated.

ARTICLE 12

ROYALTIES

(1) Royalties derived by a resident of one of the Contracting States from sources within the other Contracting State may be taxed by both Contracting States.

(2) Royalties derived by a resident of one of the Contracting States from sources within the other Contracting State shall not be taxed by the other Contracting State at a rate in excess of 10 percent of the gross amount of cultural royalties or at a rate in excess of 15 percent of the gross amount of industrial royalties.

(3) For purposes of this article—

(a) Cultural royalties are payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, including copyrights of motion picture films or films or tapes used for radio or television broadcasting;

(b) Industrial royalties are payments of any kind made as consideration for the use of, or the right to use, patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights, or for knowledge, experience, or skill (know-how);

(c) Cultural royalties and industrial royalties include gains derived from the sale, exchange, or other disposition of any such property or rights to the extent that the amounts realized on such sale, exchange, or other disposition for consideration are contingent on the productivity, use, or disposition of such property or rights.

(4) Paragraph (2) shall not apply if the recipient of the royalty, being a resident of one of the Contracting States, has in the other Contracting State a permanent establishment and the property or rights giving rise to the royalty is effectively connected with such permanent establishment. In such a case, paragraph (6) of Article 7 (Business Profits) shall apply.

(5) Where an amount is paid to a related person which would be treated as royalty but for the fact that it exceeds an amount which would have been paid to an unrelated person, the provisions of this article shall apply only to so much of the amount as would have been paid to an unrelated person. In such a case, the excess amount may be taxed by each Contracting State according to its own law, including the provisions of this Convention where applicable.

(6) Royalties shall be treated as income from sources within a Contracting State only to the extent that such royalties are payments made as consideration for the use of, or the right to use, property or rights described in paragraph (3)(a) and (b) within that Contracting State or gains described in paragraph (3)(c) from the sale, exchange, or other disposition of such property or rights.

ARTICLE 13

CAPITAL GAINS

(1) A resident of one of the Contracting States shall be exempt from tax by the other Contracting State on gains from the sale, exchange, or other disposition of capital assets (whether acquired by inheritance, gift, or any other manner) unless—

(a) The recipient of the gain, being a resident of one of the Contracting States, has a permanent establishment in the other Contracting State and the property giving rise to the gain is effectively connected with such permanent establishment, or

(b) The recipient of the gain, being an individual who is a resident of one of the Contracting States is present in the other Contracting State for a period or periods aggregating 183 days or more during the taxable year.

(2) In the case of gains described in paragraph (1)(a), paragraph (6) of Article 7 (Business Profits) shall apply.

ARTICLE 14

INDEPENDENT PERSONAL SERVICES

(1) Income derived by an individual who is a resident of one of the Contracting States from the performance of personal services in an independent capacity may be taxed by that Contracting State.

(2) Income derived by an individual who is a resident of one of the Contracting States from the performance of personal services in an independent capacity in the other Contracting State may also be taxed by that other Contracting State, but only if the individual—

(a) Is present in that other Contracting State for a period or periods aggregating 183 days or more in the taxable year,

(b) Maintains a permanent establishment in the other Contracting State with which the income is effectively connected, or

(c) Is an entertainer, such as a theater, motion picture, radio or television artist, a musician, or an athlete, and is present in that other Contracting State for a period or periods aggregating more than 90 days in the taxable year or the gross income derived from his personal services as an entertainer in an independent capacity in that other Contracting State exceeds in the aggregate 3,000 United States dollars or its equivalent in Romanian lei during the taxable year.

(3) Paragraph (2)(c) shall not apply to an entertainer described in paragraph (2)(c) who is a resident of one of the Contracting States and who is present in the other Contracting State pursuant to a specific arrangement agreed to by the two Contracting States.

ARTICLE 15

DEPENDENT PERSONAL SERVICES

(1) Except as provided in Article 18 (Governmental Functions), 19 (Teachers), and 20 (Students and Trainees), wages, salaries, and similar remuneration derived by an individual who is a resident of one of the Contracting States from labor or personal services performed as an employee, including income from services performed by an officer of a corporation or company, may be taxed by that Contracting State. Except as provided by paragraphs (2) and (3), such remuneration derived from labor or personal services performed in the other Contracting State may also be taxed by that other Contracting State.

(2) Remuneration described in paragraph (1) derived by an individual who is a resident of one of the Contracting States shall be exempt from tax by the other Contracting State if—

(a) He is present in that other Contracting State for a period or periods aggregating less than 183 days in the taxable year;

(b) He is an employee of a resident of the first-mentioned Contracting State or of a permanent establishment maintained in the first-mentioned Contracting State by a resident of the other Contracting State;

(c) The remuneration is not borne as such by a permanent establishment which the employer has in that other Contracting State; and

(d) In the case of an entertainer, such as a theater, motion picture, radio or television artist, a musician, or an athlete, he is present in that other Contracting State for a period or periods aggregating less than 90 days in the taxable year and the gross income he derives as an employee in that other Contracting State aggregates less than 3,000 United States dollars or its equivalent in Romanian lei during the taxable year.

(3) Paragraph (2)(d) shall not apply to an entertainer described in paragraph (2)(d) who is a resident of

one of the Contracting States and who is present in the other Contracting State pursuant to a specific arrangement agreed to by the two Contracting States.

(4) Notwithstanding paragraph (2), remuneration derived by an individual from the performance of labor or personal services as an employee aboard ships or aircraft operated by a resident of one of the Contracting States in international traffic shall be exempt from tax by the other Contracting State if such individual is a member of the regular complement of the ship or aircraft.

ARTICLE 16

PRIVATE PENSIONS AND ANNUITIES

(1) Except as provided in Article 18 (Governmental Functions), pensions and other similar remuneration paid to an individual in consideration of past employment shall be taxable only in the Contracting State of which he is a resident.

(2) Alimony and annuities paid to an individual who is a resident of one of the Contracting States shall be taxable only in that Contracting State.

(3) A resident of one Contracting State who receives child support payments from a resident of the other Contracting State shall be exempt from tax on such payments in both Contracting States.

(4) The term "pensions and other similar remuneration," as used in this article, means periodic payments other than social security payments covered in Article 17 (Social Security Payments) made (a) by reason of retirement or death in consideration for services rendered, or (b) by way of compensation for injuries received in connection with past employment.

(5) The term "annuities," as used in this article, means a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

(6) The term "alimony," as used in this article, means periodic payments made pursuant to a decree of divorce or compulsory support, separate maintenance agreement, or support or separation agreement which is taxable to the recipient under the internal laws of the Contracting State of which he is a resident.

(7) The term "child support payments," as used in this article, means periodic payments for the support of a minor child made pursuant to a decree of divorce, separate maintenance agreement, or support or separation agreement.

ARTICLE 17

SOCIAL SECURITY PAYMENTS

Social security payments and other public pensions paid by one of the Contracting States to an individual who is a resident of the other Contracting State shall be exempt from tax in both Contracting States. This article shall not apply to payments described in Article 18 (Governmental Functions).

ARTICLE 18

GOVERNMENTAL FUNCTIONS

Wages, salaries, and similar remuneration, including annuities or similar benefits, paid from public funds of one of the Contracting States to a citizen of that Contracting State for labor or personal services performed as an employee of the national government of that Contracting State, or any agency thereof, in the discharge of functions of a governmental nature shall be exempt from tax by the other Contracting State. Labor or personal services performed by a citizen of one of the Contracting States shall be treated by the other Contracting State as performed in the discharge of governmental functions if such labor or personal services would be treated under the internal laws of both Contracting States as so performed.

ARTICLE 19

TEACHERS

(1) Where a resident of one of the Contracting States is invited by the Government of the other Contracting State, a political subdivision, or a local authority thereof, or by a university or other recognized educational institution in that other Contracting State to come to that other Contracting State for a period not expected to exceed 2 years for the purpose of teaching or engaging in research, or both, at a university or other recognized educational institution and such resident comes to that other Contracting State primarily for such purpose, his income from personal services for teaching or research at such university Contracting State for a period not exceeding 2 years from the date of his arrival in that other Contracting State.

(2) This article shall not apply to income from research if such research is undertaken not in the public interest but primarily for the private benefit of a specific person or persons.

ARTICLE 20

STUDENTS AND TRAINEES

(1) (a) An individual who is a resident of one of the Contracting States at the time he becomes temporarily present in the other Contracting State and who is temporarily present in that other Contracting State for the primary purpose of—

(i) Studying at a university or other recognized educational institution in that other Contracting State, or

(ii) Securing training required to qualify him to practice a profession or professional specialty, or

(iii) Studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization,

shall be exempt from tax by that other Contracting State with respect to amounts described in subparagraph (b) for a period not exceeding 5 taxable years from the date of his arrival in that other Contracting State.

(b) The amounts referred to in subparagraph (a) are—

(i) Gifts from abroad for the pur-

pose of his maintenance, education, study, research, or training;

(ii) The grant, allowance, or award; and

(iii) Income from personal services performed in that other Contracting State in an amount not in excess of 2,000 United States dollars or its equivalent in Romanian lei for any taxable year.

(2) An individual who is a resident of one of the Contracting States at the time he becomes temporarily present in the other Contracting State and who is temporarily present in that other Contracting State as an employee of, or under contract with, a research of the first-mentioned Contracting State, for the primary purpose of—

(a) Acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned Contracting State or other than a person related to such resident, or

(b) Studying at a university or other recognized educational institution in that other Contracting State,

shall be exempt from tax by that other Contracting State on his income from personal services for a period not exceeding in the aggregate 5,000 United States dollars or its equivalent in Romanian lei.

(3) An individual who is a resident of one of the Contracting States at the time he becomes temporarily present in the other Contracting State and who is temporarily present in the other Contracting State for a period not exceeding 1 year, as a participant in a program sponsored by the Government of that other Contracting State, for the primary purpose of training, research, or study, shall be exempt from tax by that other Contracting State with respect to his income from personal services in respect of such training, research, or study performed in that other Contracting State in an aggregate amount not in excess of 10,000 United States dollars or its equivalent in Romanian lei.

(4) The benefits provided under Article 19 (Teachers) and paragraph (1) of this article shall, when taken together, extend only for such period of time, not to exceed 5 taxable years from the date of arrival of the individual claiming such benefits; as may reasonably or customarily be required to effectuate the purpose of the visit. The benefits provided under Article 19 (Teachers) shall not be available to an individual if, during the immediately preceding period, such individual enjoyed the benefits of paragraph (1) of this article.

ARTICLE 21

RELIEF FROM DOUBLE TAXATION

Double taxation of income shall be avoided in the following manner:

(1) In accordance with the provisions and subject to the limitations of the law of Romania (as it may be amended from time to time without changing the general principles hereof), Romania shall allow to a citizen or resident of Romania as a credit against Romanian tax the appropriate amount of income taxes paid to the United States. Such appropriate amount shall be based upon the amount of tax paid to the United States but shall not exceed the portion of Romanian tax which such citizen's or resident's net income from sources within the United States bears to his entire net income for the same taxable year.

(2) In accordance with the provisions and subject to the limitations of the law of the United States (as it may by amended from time to time without changing the general principles hereof), the United States shall allow to a citizen or resident of the United States as a credit against the United States tax the appropriate amount of taxes paid to Romania. Such appropriate amount shall be based upon the amount of tax paid to Romania, but the credit shall not exceed the portion of United States tax which such citizen's or resident's net income from sources within Romania or on income from sources outside of the United States bears to his entire net income for the same taxable year. For purposes of applying the United States credit in relation to taxes paid to Romania, the taxes referred to in paragraph (1)(a) of Article 1 (Taxes Covered) shall be considered to be income taxes.

ARTICLE 22

NONDISCRIMINATION

(1) A citizen of one of the Contracting States who is a resident of the other Contracting State shall not be subjected in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof.

(2) A citizen of one of the Contracting States who is a resident of the other Contracting State or a permanent establishment which a resident of one of the Contracting States has in the other Contracting State shall not be subject in that other Contracting State to more burdensome taxes than are generally imposed in that other Contracting State or citizens or permanent establishments of residents of third States carrying on the same activities. However, this paragraph shall not require a Contracting State to grant to citizens or permanent establishments of residents of the other Contracting State tax benefits granted by special agreements to citizens or permanent establishments of a third State.

(3) A corporation of one of the Contracting States, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than the taxation and requirements to which a corporation of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of a third State, is or may be subjected.

However, this paragraph shall not require a Contracting State to grant to corporations which are wholly or partly owned by residents of the other Contracting State tax benefits granted by special agreements to corporations which are wholly or partly owned by residents of a third State.

ARTICLE 23

MUTUAL AGREEMENT PROCEDURE

(1) Where a resident of one of the Contracting States considers that the action of one or both of the Contracting States results or will result for him in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident or a citizen. Should the resident's claim be considered to have merit by the competent authority of the Contracting State to which the claim is made, it shall endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation not in accordance with the provisions of this Convention.

(2) The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of this Convention. In particular, the competent authorities of the Contracting States may agree—

(a) To the same attribution of industrial or commercial profits to a resident of one of the Contracting States and its permanent establishment situated in the other Contracting State:

(b) To the same allocation of income, deductions, credits, or allowances between a resident of one of the Contracting States and any related person and to the readjustment of taxes imposed by each Contracting State to reflect such allocation;

(c) To the same determination of the source of particular items of income; or

(d) To the same characterization of particular items of income.

(3) The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of this article. When it seems advisable for the purpose of reaching agreement, the competent authorities may meet together for an exchange of opinions.

(4) In the event that the competent authorities reach such an agreement, taxes shall be imposed on such income, and refund or credit of taxes shall be allowed, by the Contracting States in accordance with such agreement.

ARTICLE 24

EXCHANGE OF INFORMATION

(1) The competent authorities shall exchange such information as is necessary for carrying out the provisions of this Convention or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which this Convention applies provided the information is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

(2) Any information so exchanged shall be treated as secret, except that such information may be—

(a) Disclosed to any person charged with the assessment, collection, or enforcement of, or litigation with respect to, the taxes to which this Convention applies, or

(b) Made part of a public record with respect to the assessment, collection, or enforcement of, or litigation with respect to, the taxes to which this Convention applies.

(3) No information shall be exchanged which would be contrary to public policy.

(4) If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this article in the form of depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings) to the same extent such depositions and documents can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

(5) Depositions and evidence which may be furnished in accordance with this article shall not be withheld by reason of any doctrine of law under which international judicial assistance is not accorded in tax matters.

(6) The exchange of information shall be either on a routine basis or on request with reference to particular cases. The competent authorities of the Contracting States may agree on the list of information which shall be furnished on a routine basis.

ARTICLE 25

MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR OFFICES

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions and consular offices under the general rules and norms of international law or under the provisions of special agreements.

ARTICLE 26

ASSISTANCE IN COLLECTION

(1) Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such taxes imposed by that other Contracting State as will ensure that any exemption or reduced rate of tax granted under this Convention by that other Contracting State shall not be enjoyed by persons not entitled to such benefits.

(2) In no case shall this article be construed so as to impose upon a Contracting State the obligations to carry out measures at variance with the laws or administrative practices of either Contracting State with respect to the collection of its own taxes.

ARTICLE 27

ENTRY INTO FORCE

This Convention shall be subject to

ratification and instruments of ratification shall be exchanged at Bucharest as soon as possible. It shall enter into force 1 month after the date of exchange of the instruments of ratification. The provisions shall for the first time have effect with respect to income of calendar years or taxable years beginning (or in the case of taxes payable at the source, payments made) on or after January 1, 1974.

ARTICLE 28

TERMINATION

(1) This Convention shall remain in force until terminated by one of the Contracting States. Either Contracting State may terminate the Convention at any time after 5 years from the date on which this Convention enters into force provided that notice of termination has been given through diplomatic channels at least 6 months prior to the end of the calendar year. In such event, the Convention shall cease to have force and effect as respects income of calendar years or taxable years beginning (or, in the case of taxes payable at the source, payments made) on or after January 1, next following the expiration of the 6-month period.

(2) Notwithstanding the provisions of paragraph (1) and upon prior notice to be given through diplomatic channels, the provisions of Article 17 (Social Security Payments) may be terminated by either Contracting State at any time after this Convention enters into force.

DONE at Washington, in duplicate, in the English and Romanian languages, the two texts having equal authenticity, this fourth day of December, 1973.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:

GEORGE P. SCHULTZ.

FOR THE GOVERNMENT OF THE SOCIALIST REPUBLIC OF ROMANIA:

———.

Senate Executive Report No. 94-15 1st Session

[Bracketed numerals indicate official report page numbers]

TAX CONVENTIONS WITH ICELAND, POLAND, AND ROMANIA[1]

November 11, 1975

Mr. MANSFIELD. from the Committee on Foreign Relations, submitted the following report to accompany Ex. E, 94-1; Ex. A, 94-1; Ex. B, 93-2.

The Committee on Foreign Relations, to which was referred the tax conventions with Iceland (Ex. E, 94-1); Poland (Ex. A, 94-1); and Romania [2] (Ex. B, 93-2), having considered the same, reports favorably thereon without reservation and recommends that the Senate give its advice and consent to ratification thereof.

SUMMARY OF MAJOR PROVISIONS

At the request of the Committee on Foreign Relations, the staff of the Joint Committee on Internal Revenue Taxation prepared an explanation and analysis of each of these conventions. Set forth below is a summary of the more important features of each of the conventions which was submitted by the Joint Committee staff:

* * * * *

[3] *3. Convention with Romania*

There is presently no income tax convention between the United States and Romania. Adoption of the proposed convention is desirable for a number of reasons. Over the years Romania has had extensive involvement in international commerce with the result that its tax system is relatively well developed with respect to the treatment of foreign investors. Also, it can be expected that there will be an increasing amount of economic as well as cultural contacts between the two countries which will generate an increasing amount of tax problems.

Due to the fact that Romanian tax authorities are familiar with the concept of income taxation used in the United States and Western Europe it was possible for the proposed convention to follow the model tax convention of the Organization for Economic Cooperation and development (OECD) and the recent tax conventions of the United States (for example, the Japanese and Norwegian Conventions). Thus, the proposed convention with Romania, in general, follows the approach of other U.S. income tax treaties.

The most significant feature of the proposed convention is the adoption of the "effectively connected concept" in place of the so-called "force of attraction" doctrine which appeared in earlier treaties of the United States. Accordingly, a resident of one country who derives investment income from the other country will be entitled to the reduced rates of tax provided by the proposed convention even though he has a permanent establishment in the source country as long as the income is not effectively connected with the permanent establishment. This feature is embodied in The Foreign Investors Tax Act of 1966 and other recent U.S. tax treaties.

The other more important features of the proposed convention are the following:

(1) The United States and Romania are defined to include their respective continental shelves insofar as income arising from the exploration and exploitation of natural resources on the continental shelf is concerned. The effect of this provision is to recognize a country's jurisdiction to tax income arising in connection with natural resource activities on the country's continental shelf. A definition of this type is found in other recent income tax conventions (e.g., Belgium, Norway and Trinidad and Tobago). In addition, a similar provision was added to the Internal Revenue Code by the Tax Reform Act of 1969.

[1] Sections relating to tax conventions with Iceland and Poland are not published.

[2] Page 492; Technical Explanation, page 504; Senate Executive B is not published.

(2) The reciprocal exemption for income from ship and air transportation is extended to gains arising on the sale of the ships or aircraft and to income from the use of containers in connection with the use of a ship or aircraft.

(3) The tax on income from dividends is limited to a 10-percent rate.

(4) The tax on interest income is generally limited to a 10-percent rate with an exemption on interest paid in connection with indebtedness guaranteed, insured, or indirectly financed by one of the countries or an instrumentality thereof.

(5) The tax on income from cultural royalties (including films) is limited to a 10-percent rate and the tax on income from industrial royalties is limited to a 15-percent rate.

(6) Income from the equipment rentals are subject to tax only if effectively connected with a permanent establishment in the source country.

(7) Insurance or reinsurance premiums are not to be subject to any tax at the national level unless the premium is effectively connected with a permanent establishment which the recipient has in the source country.

COMMITTEE ACTION

On Friday, November 7, 1975, the Committee on Foreign Relations held a public hearing on the Tax Conventions with Iceland, Romania, Poland and the Soviet Union. At that time Mr. Charles M. Walker, Assistant Secretary of the Treasury for Tax Policy, testified in support of the conventions. His prepared statement is reprinted in the appendix to this report. Mr. Walker also submitted a technical memorandum on each of the conventions, and these will be made a part of the Committee's hearing record. Mr. Howard Silverstone, International Tax Counsel, represented the staff of the Joint Committee on Internal Revenue Taxation. He testified and submitted an explanation and analysis of each of the conventions which will also be incorporated in the Committee's hearing record.

On the same day, in an open session, the Committee ordered the Tax Conventions with Iceland, Poland and Romania reported favorably to the Senate for advice and consent to ratification. At the same time, the Committee decided to defer action on the Tax Convention with the Soviet Union until a later date.

* * * * *

[7] APPENDIX

STATEMENT OF HON. CHARLES M. WALKER, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY ON U.S. INCOME TAX CONVENTIONS WITH ICELAND, ROMANIA, POLAND, AND THE UNION OF SOVIET SOCIALIST REPUBLICS

Mr. Chairman and members of this distinguished committee, I am pleased to appear here today to testify in support of four new income tax conventions, with Iceland, Romania, Poland, and the Union of Soviet Socialist Republics.

I will keep my remarks brief, since the technical memorandum submitted with each of the proposal conventions describes the provisions in some detail. However, I would like to summarize the general objectives of our income tax conventions, and to make a few observations on the provisions used to achieve these objectives in the four conventions before you.

General Income Tax Treaty Objectives

A basic objective of our income tax conventions, as their full titles imply, is to prevent double taxation of income. But fundamentally, our treaties are also intended to facilitate trade and investment between the United States and our treaty partners. Our tax treaties play an important role in this respect by providing greater certainty as to the rules of taxation for foreign business and investment and by clarifying the inter-action of U.S. foreign laws; they eliminate, where appropriate, the need to file tax returns and to become conversant with the details of the tax of more than one country; they provide a mechanism for bilateral cooperation by the tax authorities with respect to the resolution of tax conflicts; they contain provisions facilitating the exchange of scholars, engineers, technicians and others; and they seek to achieve tax neutrality with respect to the flow of capital. The treaties thereby complement other efforts by the U.S. to promote free trade and capital movements. At the same time, they provide a bilateral mechanism for cooperation between government tax authorities in the administration of their laws.

Our tax treaties basically follow the model prepared by the Fiscal Committee of the Organization for Economic Cooperation and Development. This model has served as the basis for hundreds of bilateral conventions between the OECD member countries. The United States today has more than 30 treaties in force and a dozen or more in various stages of negotiation.

Our income tax conventions avoid double taxation by establishing rules for dividing or assigning taxing jurisdiction between the country of the taxpayer's residence and the country where the income arises (the country of source). Where there is only a temporary or minimal presence in the source country, the conventions typically provide for taxation exclusively by residence country. Thus, ordinarily business income is not taxable in the source country unless the taxpayer has a fixed place of business there, and employees temporarily in the source state are not taxable on their wages in that state unless they are there for a substantial period of time. Withholding taxes at the source on passive income in the form of dividends, interest and royalties are usually reduced or eliminated under the treaties.

Where a convention permits both countries to tax income, it typically requires the residence country to grant a foreign tax credit for the source country tax. In addition, the source country tax on dividends, interest and royalties, where not eliminated by the convention, is generally subject to a

maximum rate which is intended to ensure that the tax may be fully credited against the residence country tax.

Our income tax conventions are not designed to alter the U.S. tax liability of U.S. residents, corporations or citizens. U.S. taxpayers continue to be taxed according to our law. The conventions are designed to obtain tax benefits for U.S. corporations and residents from our treaty partners in exchange for similar benefits which we grant to their taxpayers.

The conventions also typically guarantee that taxpayers from one country will not be subject to discriminatory taxes in the other country. And they provide for administrative cooperation in avoiding double taxation and in preventing fiscal evasion.

* * * * *

[10] *Convention with Romania*

Let me turn now to the convention with Romania. Although state enterprises play a large role in the Romanian economy, there is also a substantial private sector in which foreign capital is invited to participate. It is possible for a foreign investor to establish a jointly owned Romanian corporation with local capital, provided that the foreign investor owns less than 50 percent of the equity.

A tax of 30 percent is imposed on the profits of such corporations, and dividends remitted to the foreign shareholders are subject to a 10 percent withholding tax. In many respects Romanian tax principles are similar to our own and to those of Western Europe. The convention reflects this common ground and differs very little from the convention with Iceland.

Business income.—For example, the Romanian convention contains the usual rule that a resident of one country may be taxed by the other country on business income only to the extent that the income is attributable to a permanent establishment in the taxing country. The convention with Romania introduces an explicit rule which we think is implicit in most of our existing conventions; it specifically permits items displayed at a trade fair in the host country to be sold off at the close of the fair without incurring tax liability to the host country.

Passive income.—The reciprocal withholding rates agreed on for the maximum tax at source on dividends, interest and royalties are within the usual agreed limits. The dividend withholding rate may not exceed 10 percent, the rate on interest may also not exceed 10 percent and in some cases is set at zero, and the maximum rate on royalties is 10 percent in some cases and 15 percent in others.

Personal service income.—Personal service income may be taxed by the source country if the recipient stays there longer than six months, or in the case of a self employed person if he maintains a fixed place of business ("fixed base") there to which the income is attributable. Although not in the Iceland convention the "fixed base" concept is found in the OECD model and in some other U.S. conventions. Although not defined, the "fixed base" is the same as the "permanent establishment" concept but applied to independent personal service income rather than industrial or commercial profits.

Teachers and students may remain longer than six months—from one to five years depending on the purpose of the visit—and continue to be exempt from tax on certain amounts of income. Entertainers become subject to tax after three months or if their earnings exceed $3,000, except that entertainers whose visit is pursuant to an agreement between the two countries enjoy the longer six-month exemption.

The convention includes the standard rule that each country will exempt employees of the other sent to perform governmental functions, but for activities to qualify as governmental functions they must be so regarded by both countries. This qualification condition is not necessarily intended to produce a different result from that of our other conventions, but simply to avoid misunderstanding in a situation where the role of the state in the two economies differs substantially.

Nondiscrimination. — The nondiscrimination article in the Romanian convention is different from the typical nondiscrimination article. U.S. citizens resident in Romania may not be more heavily taxed than resident Romanian citizens. This is a standard provision in our income tax conventions. However, the taxes imposed by Romania on resident U.S. citizens, or on permanent establishments or subsidiaries owned by U.S. residents may not be more burdensome than the taxes imposed on third country citizens or businesses in Romania, subject to differences in treatment under special agreements, such as tax treaties. The comparison with other foreign businesses was thought more appropriate than with domestic businesses given the large role of state enterprises which are subject to different and frequently heavier taxation than private firms.

Administrative cooperation.—Guidelines for administrative cooperation are also provided along lines similar to those in the Iceland convention.

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[13] TEXTS OF RESOLUTIONS OF RATIFICATION

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[14] *Resolved, (Two-thirds of the Senators present concurring therein),* That the Senate advise and consent to the ratification of the Convention between the Government of the United States of America and the Government of the Socialist Republic of Romania with respect to Taxes on Income, signed at Washington on December 4, 1975 (Ex. B, 93-2).

Technical Explanation[1] of the Convention Between the United

[1] It is the practice of the Treasury Department to prepare for the use of the Senate and other interested persons a Technical Explanation of the tax conventions which are submitted to the Senate for its advice and consent to ratification.

An Income Tax Convention with Romania was signed December 4, 1973, and

States of America and the Socialist Republic of Romania with Respect to Taxes on Income, Signed at Washington On December 4, 1973[2]

ARTICLE 1. TAXES COVERED

Paragraph (1) designates the taxes of the Contracting States which are the subject of the Convention. With respect to the United States, the subject taxes are the Federal income taxes imposed by the Internal Revenue Code ("Code"), including the taxes imposed under section 531 (accumulated earnings tax) and section 541 (personal holding company tax). However, the Convention does not apply to the taxes imposed by chapters 2 (tax on self-employment income) and 21 (federal insurance contributions act) of the Code. These taxes are described as social insurance taxes to facilitate translation into Romanian.

In the case of Romania, paragraph (1) provides that the Convention applies to income taxes imposed under Romanian law, and in particular to the income taxes imposed on wages, salaries, fees, copyrights, and income from any other source received by individuals, on the profits of mixed companies, on enterprises other than mixed companies or state enterprises, on agricultural activities, on rentals, and on nonresidents.

Pursuant to paragraph (2), the Convention will also apply to taxes substantially similar to those covered by paragraph (1) which are imposed in addition to, or in place of, existing taxes, after the date of signature of the Convention (December 4, 1973).

For purposes of paragraph (5) of Article 7 (Business Profits) which deals with insurance and reinsurance premiums, the Convention also applies to taxes other than income taxes imposed at the national level of a Contracting State on such premiums paid to a resident of the other Contracting State. The effect of this provision is discussed under Article 7 (Business Profits).

Pursuant to paragraph (3), for purposes of Article 22 (Nondiscrimination), the Convention applies to taxes of every kind which are imposed at the national, state, or local level.

Paragraph (4) provides that the competent authority of each Contracting State will notify the competent authority of the other Contracting State of any amendment of the tax laws referred to in paragraph (1), or of the adoption of substantially similar taxes imposed in addition to, or in place of, those taxes. The texts of such amendments or new statutes are to be transmitted between the competent authorities at least once a year.

ART. 2. GENERAL DEFINITIONS

Paragraph (1) sets out definitions of certain basic terms used in the Convention. A number of important terms, however, are defined elsewhere in the Convention.

The term "Romania" means the Socialist Republic of Romania. The term "United States" means the United States of America. When used in a geographical sense, the term "United States" means the states of the United States and the District of Columbia. Thus, the Convention does not apply to the possessions of the United States or the Commonwealth of Puerto Rico. When used in a geographical sense, Romania and the United States also include their respective territorial seas and continental shelves, generally in accordance with the principles of section 638 of the Code.

The term "Contracting State" is defined to mean the United States or Romania as the context requires. Although not specifically defined in the Convention, the term "State" means the United States, Romania, or any other national State.

The term "person" is defined as including an individual, a partnership, a corporation, an estate or a trust.

The term "United States corporation" is defined as a corporation, or any entity (whether or not incorporated) treated as a corporation for United States tax purposes, which is created or organized under the laws of the United States, any state thereof, or the District of Colombia. A "Romanian corporation" is defined as any juridical person, including a mixed corporation, which is incorporated and organized under Romanian law or any other legal entity which is created under Romanian law and which is treated under its tax laws as a juridical person.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to Romania, it means the Minister of Finance or his delegate. The term "tax" means those taxes imposed by the United States or Romania to which the Convention applies by virtue of Article 1 (Taxes Covered).

The term "international traffic" is defined as any voyage of a ship or aircraft operated by a resident of one of the Contracting States except where such voyage is confined solely to places within a Contracting State. Thus, for example, coastal shipping along the Atlantic coast of the United States is not a voyage in international traffic. However, if a ship operated by a resident of Romania transports goods from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the portion of the voyage between New York and Norfolk is international traffic.

Paragraph (2) provides that any term used in the Convention which is not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined. However, where a

submitted by the President to the Senate on March 11, 1974. On November 7, 1975, the Senate Committee on Foreign Relations held hearings and this Technical Explanation was presented. The Senate voted its advice and consent on November 18, 1975, and instruments of ratification were exchanged on January 26, 1976, the convention thereby entering into force on February 26, 1976.

[2] Page 492; pertinent excerpts from Senate Executive Report No. 94-15, page 502; Senate Executive B is not published.

term has a different meaning under the laws of Romania and the United States or where the meaning under the laws of one of the Contracting States is not readily determinable, the competent authorities may for purposes of the Convention establish a common definition in order to prevent double taxation or to further any other purpose of the Convention.

ART. 3. FISCAL RESIDENCE

This article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. Residence is important because, in general, only a resident of one of the Contracting States may qualify for the benefits of the Convention.

Under paragraph (1), the term "resident of Romania" means a Romanian corporation as defined in Article 2 (General Definitions) or any other person who is resident in Romania for purposes of its tax. Similarly, "resident of the United States" means a United States corporation as defined in Article 2 (General Definitions) and any other person resident in the United States for purposes of its tax. Thus, a resident of the United States includes a resident alien individual and a resident citizen but not a foreign corporaiton. A citizen of the United States or Romania is not automatically a resident of the United States or Romania for purposes of this Convention. Similarly, even if a foreign corporation, or other foreign entity treated as a foreign corporation, is treated as a resident (see, *e.g.*, 26 CFR § 301.7701-5 of the U.S. Treasury Regulations) or a domestic corporation for certain purposes of a Contracting State's income tax law, such corporation or entity will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, even though a foreign corporation is taxed by the United States on its trade or business income from sources within the United States, or a foreign corporation is referred to as a resident of the United States in the source rules in section 861 of the Code, such corporation is not a resident of the United States for purposes of the Convention.

The Convention provides that a partnership, estate, or trust is a resident of a Contracting State only to the extent that the income derived by such person is subject to tax in such Contracting State. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the Convention, income received by a partnership, estate, or trust will not be treated for purposes of the Convention as income received by a resident of the United States unless such income is subject to tax by the United States as the income of a resident. Thus, the treatment of income received by a partnership will be determined by the residence and taxation of its partners with respect to that income. To the extent the partners are subject to United States tax as residents of the United States, the partnership will be treated as a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the persons subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

Under paragraph (2), an individual who is a resident of both Contracting States under their domestic laws will, for purposes of the Convention, be deemed to be a resident of the Contracting State in which he has his permanent home, his center of vital interests (closest economic and personal relations), a habitual abode, or his citizenship, in the order listed. If the issue is not settled by these tests, the competent authorities will decide by mutual agreement the one Contracting State of which he will be considered to be a resident.

ART. 4. GENERAL RULES OF TAXATION

Under paragraph (1), a resident of one Contracting State may be taxed by the other Contracting State only on income from sources within that other Contracting State, subject to the limitations set forth in the Convention. For this purpose, the source rules contained in various articles articles throughout the Convention are to be applied. However, if the resident is a citizen of the other Contracting State, that Contracting State may tax the resident without regard to this paragraph because of the saving clause of paragraph (3) of this article.

Paragraph (2) contains the customary rule that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of a tax imposed by it, or by any other agreement between the Contracting States. This rule reflects the principle that a convention should not increase the tax burden on residents of the Contracting States.

Paragraph (3) contains the traditional saving clause under which the United States reserves the right to tax its citizens and residents as if the Convention had not come into effect. However, the saving clause does not apply in several cases in which its application would contravene policies reflected in the Convention. Thus, the saving clause does not affect the provisions with respect to social security payments, relief from double taxation, nondiscrimination, or the mutual agreement procedure. Moreover, the saving clause does not affect the benefits of the Convention to individuals performing governmental functions, teachers, students, trainees, and members of diplomatic missions and consular offices who become resident in one of the Contracting States unless such individuals are citizens of or have immigrant status in the Contracting State imposing the tax. In the case of the United States, "immigrant status" means the individual has been admitted to the United States for perma-

nent residence. The saving clause is reciprocal.

Paragraph (5) authorizes the competent authorities of the Contracting States to prescribe regulations necessary to carry out the provisions of the Convention. On the United States side, this authority is also provided by section 7805 of the Code.

ART. 5. PERMANENT ESTABLISHMENT

This article defines the term "permanent establishment." The existence of a permanent establishment is relevant under Article 7 (Business Profits) to the taxation of industrial or commercial profits and in determining the applicability of other provisions of the Convention, such as Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 13 (Capital Gains).

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which the business of a resident of one of the Contracting States is wholly or partly carried on. Illustrations in paragraph (2) of a permanent establishment include a branch, an office, a factory; a workshop; a warehouse; a mine, quarry or other place of extraction of natural resources; and a construction or installation project which exists for more than 12 months. As a general rule, any fixed facility or premises through which a resident conducts industrial or commercial activity for an indefinite or substantial period of time will be treated as a permanent establishment unless it is used for one or more of the activities described in paragraph (3).

The term "construction or installation project" includes a building site. Under the construction or installation project rule the twelve month period begins only when work physically commences in the other Contracting State. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the twelve months' test.

Paragraph (3) specifically provides that a permanent establishment does not include a fixed place of business if it is used only for one or more of the following:

"(a) The use of facilities for the purpose of storage, display, or delivery pursuant to a sales contract, of goods or merchandise belonging to the resident;

"(b) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of processing by another person;

"(c) The maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the resident;

"(d) The maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the resident; or

"(e) The maintenance of a construction or installation project which does not exist for more than 12 months."

These exceptions are cumulative and a fixed place of business used solely for one or more of these purposes will not be considered a permanent establishment under the Convention. Subparagraph (a) states that delivery must be pursuant to a sales contract to emphasize the implicit restriction that a facility used for delivering another person's goods would not be included within the exception. Since the subparagraph excludes the use of facilities for storage, display or delivery, by implication it also excludes the stock of goods or merchandise itself from being deemed a permanent establishment. The construction or installation project exception in subparagraph (e) is the converse of the rule of paragraph (2) that such a project which exists for more than 12 months will be a permanent establishment.

Under paragraph (4) a person acting in one Contracting State on behalf of a resident of the other Contracting State, other than an agent of an independent status to whom paragraph (5) applies, will be deemed to give rise to a permanent establishment if such person has, and habitually exercises in the first-mentioned Contracting State, an authority to conclude contracts in the name of the resident, unless the exercise of the authority is limited to the purchase of goods or merchandise for the resident.

On the other hand, paragraph (5) provides that a resident of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such resident engages in industrial or commercial activity in such other Contracting State through a broker, general commission agent, or any other agent of an independent status, if such agent is acting in the ordinary course of its business.

Paragraph (6) provides that a resident of one Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident sells at the termination of a trade fair or convention in the other Contracting State goods or merchandise which were displayed by such resident at the trade fair or convention. This exception does not appear in existing United States conventions, but a similar exception is contained in the pending conventions with the Soviet Union and Poland.

Under paragraph (7), the determination of whether a resident of one Contracting State has a permanent establishment in the other Contracting State is to be made without regard to the fact that such resident may be related to a resident of the other Contracting State or to a person who engages in business in that other Contracting State (whether through a permanent establishment or otherwise). As defined in Article 9 (Related Persons), a person is related to another person if either person owns or controls directly or indirectly the either, or if a third person or persons

own or control directly or indirectly both such persons.

Paragraph (8) provides that the principles set forth in this article are to be applied in determining whether there is a permanent establishment in a State other than one of the Contracting States or whether a person other than a resident of one of the Contracting States has a permanent establishment in one of the Contracting States. This is necessary for the proper application of paragraph (7) of Article 11 (Interest). This paragraph is not intended to extend the benefits of the Convention to persons other than residents of the two Contracting States.

ART. 6. INCOME FROM IMMOVABLE PROPERTY

Under paragraph (1), income from immovable property, including royalties and other payments in respect of the exploitation of natural resources, e.g., oil wells, and gains from the sale, exchange or other disposition of such property or of the right giving rise to such royalties or other payments, may be taxed by the Contracting State in which the immovable property or natural resources are situated. However, income from immovable property does not include interest on indebtedness secured by immovable property (e.g., mortgages) or by a right giving rise to royalties or other payments in respect of the exploitation of natural resources. Such interest income is covered by Article 11 (Interest).

Paragraph (1) applies to income derived from the usufruct, direct use, letting, or use in any other form of immovable property. For United States purposes, the term "immovable property" is intended to have the same meaning as the term "real property."

ART. 7. BUSINESS PROFITS

Paragraph (1) sets forth the general rule that industrial or commercial profits of a resident of one Contracting State are exempt from tax by the other Contracting State unless the resident has a permanent establishment in the other Contracting State. Where there is a permanent establishment, only the industrial or commercial profits attributable to the permanent establishment can be taxed by that other Contracting State, unless the resident is a citizen of the other Contracting State. (See the saving clause in paragraph (3) of Article 4 (General Rules of Taxation).) It is intended that, for purposes of the Convention, including paragraph (1) of Article 4 (General Rules of Taxation) and Article 21 (Relief from Double Taxation), industrial or commercial profits whether from sources within or without a Contracting State attributable to a permanent establishment which a resident of one Contracting State has in the other Contracting State will be considered to be from sources within that other Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code attributable to a permanent establishment situated in the United States will be subject to tax by the United States.

In determining the proper attribution of industrial or commercial profits under the Convention, paragraph (2) provides that both Contracting States will attribute to the permanent establishment such profits as it would reasonably be expected to derive if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the resident of which it is a permanent establishment. Under paragraph (3), expenses, wherever incurred, which are reasonably connected with profits attributable to the permanent establishment, including executive and general administrative expenses, will be allowed as deductions in determining the industrial or commercial profits of the permanent establishment. However, in determining the amount of the deduction under paragraph (3) for expenses incurred by the head office, the deduction may be limited to the expense incurred without including a profit element for the head office.

Paragraph (4) provides that no profits shall be attributed to a permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment, or by the resident of which it is a permanent establishment, for the account of such resident. Paragraph (2) of the article does not override paragraph (4). Thus, where a permanent establishment purchases goods for its head office, the industrial and commercial profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a notional figure for profits from purchasing.

Under paragraph (5), insurance or reinsurance premiums derived by a resident of one Contracting State from sources within the other Contracting State cannot be subjected to an income tax or to any other tax in the other Contracting State unless the premiums are effectively connected with a permanent establishment in the other Contracting State. In the case of the United States, this includes the stamp tax imposed by section 4371 of the Code on foreign insurance policies covering risks in the United States. Except for the extension of the exemption to include non-income taxes, which has no counterpart in existing United States conventions, this paragraph reaches the same result as would be reached under paragraphs (1) and (6) of the article, since premiums are industrial or commercial profits to an insurance company.

Under paragraph (6), the term "industrial or commercial profits" includes income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, and the rental of tangible personal (movable) property. The term does not include income from the performance of personal services derived by an individual either as an employee or in an independent capacity (although such income may be effectively connected with a permanent establish-

ment and therefore taxable under paragraph (2)(b) of Article 14 (Independent Personal Services)). The term also includes income derived from real property and natural resources, dividends, interest, investment income on required reserves from insurance activities, cultural and industrial royalties and capital gains, but only if the property or rights giving rise to such income are effectively connected with a permanent establishment. See paragraph (3) of Article 10 (Dividends), paragraph (4) of Article 11 (Interest), paragraph (4) of Article 12 (Royalties) and paragraph (1)(a) of Article 13 (Capital Gains).

Paragraph (7) contains criteria for determining whether property or rights are effectively connected with a permanent establishment. Factors to be taken into account include whether the rights or property are used in or held for use in carrying on an activity giving rise to industrial or commercial profits through a permanent establishment and whether the activities carried on through such permanent establishment were a material factor in the realization of the income derived from such property or rights. For this purpose, due regard shall be given to whether or not such property or rights or such income were accounted for through such permanent establishment. The effectively connected concept in this paragraph is substantially similar to the effectively connected concept in section 864(c)(2) of the Code.

Under paragraph (8), where industrial or commercial profits include items of income which are dealt with separately in other articles of the Convention, the provisions of those articles will, except as otherwise provided therein, supersede the provisions of this article. Thus, for example, taxation of income from copyrights of motion picture films or films or tapes used for radio or television broadcasting will be controlled by Article 12 (Royalties) and not by this article unless the copyright is effectively connected with a permanent establishment.

ART. 8. SHIPPING AND AIR TRANSPORT

Paragraph (1) provides that, notwithstanding Article 7 (Business Profits) and Article 13 (Capital Gains), income derived by a resident of one Contracting State from the operation in international traffic of ships or aircraft registered in that Contracting State, and gains derived from the sale, exchange or other disposition of such ships or aircraft, shall be exempt from tax by the other Contracting State.

This article also applies to income derived from the rental of ships or aircraft under a full or bareboat charter if the lessor is engaged in the operation of ships or aircraft in international traffic and the rental income is incidental to such operations. For example, if an airline which is a resident of one Contracting State has excess equipment in the winter months and leases several of its aircraft which are not required by it during that period to an airline which is a resident of the other Contracting State, that rental income of the lessor is not subject to tax by that other Contracting State, whether or not the lessee uses the aircraft in international traffic.

Paragraph (2) makes clear that the article also applies to income derived by a resident of one Contracting State from the use, maintenance, and lease of containers and other related equipment in connection with the operation in international traffic by the resident of ships or aircraft registered in such Contracting State. An example of such other related equipment is a trailer for the inland transportation of containers in connection with such operations.

This article is subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Therefore, the other Contracting State may tax the resident without regard to this article if such resident is a citizen of that other Contracting State.

ART. 9. RELATED PERSONS

Where a person subject to the taxing jurisdiction of a Contracting State (whether or not a resident thereof) and any other related person make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, under paragraph (1) any income, deductions, credits or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income or loss of, or the tax payable by, one of such persons, may be taken into account in computing the amount of the income subject to tax and the taxes payable by such person in that Contracting State.

Paragraph (2) sets forth an explicit formulation of the consequence of an adjustment made in accordance with paragraph (1) by a Contracting State to the income of one of its residents. In such event, the other Contracting State must, if it agrees with such redetermination, make a corresponding adjustment to the income of a person in such other Contracting State related to such resident. If the other Contracting State disagrees with the redetermination, the two Contracting States must endeavor to reach agreement in accordance with the mutual agreement procedure in paragraph (2)(b) of Article 23 (Mutual Agreement Procedure).

Paragraph (3) provides that for purposes of the Convention a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both. "Control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

ART. 10. DIVIDENDS

Paragraph (1) provides that dividends paid by a corporation of one Contracting State to a resident of the other Contracting State may be taxed by both Contracting States. However, paragraph (2) limits the rate of tax in the former Contracting State to a

rate not in excess of 10 percent of the gross amount of the dividend. This limitation does not affect the taxation of profits of the corporation which pays the dividend.

The ten percent limitation does not apply if the recipient, being a resident of the other Contracting State has a permanent esablishment in the former Contracting State and the shares with respect to which the dividends are paid are effectively connected with such permanent establishment. In such a case, under paragraph (6) of Article 7 (Business Profits) the dividends are treated as industrial or commercial profits. If the recipient is a citizen of the Contracting State of which the corporation paying the dividend is a resident, that Contracting State may tax the recipient without regard to this aricle because of the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). It is intended that, for purposes of Article 21 (Relief from Double Taxation), dividends paid by a corporation of a Contracting State are from sources within that Contracting State.

ART. 11. INTEREST

Paragraph (1) provides that interest derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, paragraph (2) limits the rate of tax in that other Contracting State to a rate not in excess of ten percent of the gross amount of the interest.

Paragraph (3) provides that interest beneficially derived by one of the Contracting States, or by an instrumentality of that Contracting State not subject to tax by that Contracting State on its income, will be exempt from tax by the other Contracting State. Under this rule, interest income derived by the Export-Import Bank of the United States and the Overseas Private Investment Corporation (OPIC) on loans made to Romanian residents will be exempt from tax in Romania. The exemption also applies where a resident of a Contracting State receives interest income with respect to indebtedness, i.e., debt obligations, guaranteed, insured, or indirectly financed by that Contracting State or an instrumentality thereof. An example of indirect financing is where an instrumentality of a Contracting State provides funds in the form of an export credit or import credit to a resident thereof for purpose of permitting that resident to extend credit to a resident of the other Contracting State. This concept of indirect financing is also found in the exchange of notes accompanying our recent Japanese Convention.

Paragraph (4) provides that the rate limitation in paragraph (2) does not apply if the recipient of the interest, being a resident of one Contracting State, has a permanent establishment in the other Contracting State and the indebtedness giving rise to the interest is effectively connected with such permanent establishment. In such a case, under paragraph (6) of Article 7 (Business Profits) the interest will be treated as industrial or commercial profits of the recipient.

If excessive interest is paid to a related person, paragraph (5) provides that the rate limitations of the article do not apply to the excessive portion of the payment. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. In the case of the United States, the excessive portion may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) may apply.

Paragraph (6) defines interest for purposes of the Convention as income from bonds, Government securities, notes or other evidences of indebtedness, whether or not secured and whether or not carrying a right to participate in profits, and debt-claims of every kind, as well as all other income which, under the taxation law of the Contracting State in which the income has its source, is assimilated to income from money lent.

Paragraph (7) sets forth the source rules for interest. With two exceptions, interest will be treated as income from sources within a Contracting State only if paid by that Contracting State, or a political subdivision or local authority thereof, of resident of that Contracting State. Under the first exception, if the person paying the interest (whether or not such person is a resident of one of the Contracting States) has a permanent establishment in one of the Contracting States in connection with which the indebtedness on which the interest is paid was incurred and such interest is borne by the permanent establishment, the interest will be deemed to be from sources within the Contracting State in which the permanent establishment is situated. This exception permits a Contracting State, under the proper circumstances, to impose a tax on interest paid by a permanent establishment therein including a permanent establishment in Romania which borrows money from a resident of the United States and bears the interest, the interest will be deemed to be from Romanian sources. Thus, Romania may tax such income, subject to the limitations of this article. As provided in paragraph (8) of Article 5 (Permanent Establishment), the rules of Article 5 will be applied to determine whether the resident of France has a permanent establishment in Romania. The United States will not, because of section 861(a)(1) of the Code, impose a tax on interest received by nonresident alien individuals or foreign corporations from a Romanian corporation having a permanent establishment in the United States unless 50 percent or more of the gross income of such corporation from all sources for the three-year period ending with the close of its taxable year preceding the payment of the interest was effectively connected with conduct of a trade or business within the United States.

Under the second exception, if the person paying the interest is a resident of one of the Contracting

States and has a permanent establishment in a State other than a Contracting State in connection with which the indebtedness on which the interest is paid was incurred and such interest is paid to a resident of the other Contracting State, and such interest is borne by such permanent establishment, the interest will be deemed to be from sources within the State in which the permanent establishment is situated. Interest described in the second exception will be exempt from tax in the Contracting State where the payor is a resident because, under Article 4 (General Rules of Taxation), a resident of one Contracting State not a citizen of the other Contracting State may be taxed by that other Contracting State only on income from sources within that other Contracting State. For example, if a resident of the United States has a permanent establishment in France which borrows money from a resident of Romania and bears the interest, the interest will be deemed to be from French sources. Thus, the United States may not tax such income if the recipient resident of Romania is not a citizens of the United States. As provided in paragraph (8) of Article 5 (Permanent Establishment), the rules of Article 5 will be applied to determine whether the resident of the United States has a permanent establishment in France.

This article is subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Therefore, interest derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this article.

ART. 12. ROYALTIES

Paragraph (1) provides that royalties derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, paragraph (2) limits the tax in that other Contracting State to a rate not to exceed 10 percent of the gross amount of cultural royalties or 15 percent of the gross amount of industrial royalties.

The term "cultural royalties" is defined as payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, including copyrights of motion picture films or films or tapes used for radio or television broadcasting. The term "industrial royalties" is defined as payments of any kind made as consideration for the use of, or the right to use, patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights, or for knowledge, experience or skill (know-how). Cultural royalties and industrial royalties include gains derived from the sale, exchange, or other disposition of such property or rights to the extent the amounts realized on such sale, exchange or other disposition for consideration are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not so contingent, the provisions of Article 13 (Capital Gains) may apply.

Paragraph (4) provides that tax rate limitations of paragraph (2) shall not apply if the recipient of the royalty, being a resident of one Contracting State, has a permanent establishment in the other Contracting State and the property or right giving rise to the royalty is effectively connected with the permanent establishment. In such a case, under paragraph (6) of Article 7 (Business Profits), the royalties will be treated as industrial or commercial profits.

If excessive royalties are paid to a related person, paragraph (5) provides that the provisions of the article do not apply to the excessive portion of the royalty. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. Thus, the excessive portion may be treated as a dividend or interest, or in whatever other manner is appropriate.

Paragraph (6) provides that royalties will be treated as income from sources within a Contracting State only to the extent they are payments made as consideration for the use of, or the right to use, property or rights described in paragraph (3) within that Contracting State or gains from the sale, exchange, or other disposition of such property or rights. This source rule is similar to the source rule in section 861(a)(4) of the Code.

This article is subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Therefore, royalties derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this article.

ART. 13. CAPITAL GAINS

Under paragraph (1), a resident of one Contracting State will be exempt from tax by the other Contracting State on gains from the sale, exchange, or other disposition of capital assets, e.g., stock or securities, whether such capital assets were acquired by inheritance, gift or any other manner. However, the exemption does not apply if (1) the recipient of the gain, being a resident of one Contracting State, has a permanent establishment in the other Contracting State and the property giving rise to the gain is effectively connected with the permanent establishment, or (2) the recipient of the gain, being an individual resident of one Contracting State, is present in the other Contracting State for a period or periods aggregating 183 days or more during the taxable year. If the recipient of the gain is a citizen of the other Contracting State, that Contracting State may tax the recipient without regard to this article because of the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). The term "day" for purposes of this article and the other physical presence tests contained in the Convention with regard to an individual means a calendar day during any portion of which the individual is physically present in the relevant Contracting State. Where Articles 6 (In-

come from Immovable Property), 8 (Shipping and Air Transport) or 12 (Royalties) apply to gains derived from the sale, exchange, or other disposition of rights or property which are covered by those articles, this article does not apply to such gains.

Paragraph (2) provides that gains which are effectively connected with a permanent establishment which the recipient has in the other Contracting State will be treated as industrial or commercial profits under paragraph (6) of Article 7 (Business Profits).

Art. 14. Independent Personal Services

In dealing with the taxation of income from personal services the Convention distinguishes between "independent" and "dependent" personal services. The Convention also provides special treatment for individuals who are "entertainers."

Independent personal services are services performed by an individual in an independent capacity (for his own account) where he receives the income and bears the losses arising from such services. If an individual is an independent contractor he is considered as rendering independent personal services. Generally, services rendered by physicians, lawyers, engineers, architects, dentists and accountants performing personal services as sole proprietors or partners are independent personal services.

Under paragraph (1), income derived by an individual resident of one Contracting State from the performance of personal services in an independent capacity may be taxed by that Contracting State. However, under paragraph (2) such income derived from services performed in the other Contracting State may also be subject to tax in that other Contracting State if: (a) the individual is present therein for a period or periods aggregating 183 days or more in the taxable year; (b) the individual maintains a permanent establishment therein with which the income is effectively connected; or (c) the individual is an entertainer, such as a theater, motion picture, radio or television artist, a musician, or an athlete, who is present therein for a period or periods aggregating more than 90 days in the taxable year or the gross income derived from his personal services as an entertainer in an independent capacity therein exceeds in the aggregate $3,000 or its equivalent in Romanian lei during the taxable year. Under the saving clause of paragraph (3) of Article 4 (General Rules of Taxation), the other Contracting State may also tax any individual who is a citizen of that Contracting State without regard to this article.

Under paragraph (3), the exemption of an entertainer is determined without reference to the 90 day or $3,000 test of paragraph 2(c) if the entertainer is a resident of one Contracting State and is present in the other Contracting State pursuant to a specific arrangement agreed to by the Contracting States. It is contemplated that such a specific arrangement would be agreed to by the Contracting States under the Cultural Relations Agreement between the United States and Romania signed on December 15, 1972 (23 U.S.T. 3741, T.I.A.S. No. 7524). It is not contemplated that an exchange of artists that was merely encouraged by both Governments, or a visit by a Romanian performer to the United States that was merely encouraged by an agency of the United States Government, would qualify as such a specific arrangement. However, a specific arrangement need not name the individual performer if he is a member of a group that is clearly identified by the arrangement, such as, for example, a city orchestra.

Art. 15. Dependent Personal Services

Under paragraph (1), wages, salaries, and similar remuneration derived by an individual who is a resident of one Contracting State from labor or personal services performed as an employee, including income from services performed by an officer of a corporation or company, may be taxed by that Contracting State, except as provided in Articles 18 (Governmental Functions), 19 (Teachers), and 20 (Students and Trainees).

Such income derived from labor or personal services performed in the other Contracting State may also be taxed in that other Contracting State unless: (a) the individual is present in that other Contracting State for a period or periods aggregating less than 183 days during the taxable year; (b) the individual is an employee of a resident of the first-mentioned Contracting State or of a permanent establishment maintained in the first-mentioned Contracting State by a resident of the other Contracting State; (c) the remuneration is not borne as such by a permanent establishment which the employer has in the other Contracting State; and (d) in the case of an entertainer, such as a theater, motion picture, radio or television artist, a musician, or an athlete, he is present in the other Contracting State for a period or periods aggregating less than 90 days in the taxable year and the gross income he derives as an employee in the other Contracting State aggregates less than $3,000 or its equivalent in Romanian lei during the taxable year. Such income may also be taxed by that other Contracting State without regard to this article if the individual is a citizen of that Contracting State, because of the saving clause of paragraph (3) of Article 4 (General Rules of Taxation).

Under paragraph (3), the exemption of an entertainer is determined without reference to the 90 day and $3,000 test of paragraph 2(d) if the entertainer is a resident of one Contracting State and is present in the other Contracting State pursuant to a specific arrangement agreed to by the Contracting States. See the discussion under Article 14 (Independent Personal Services) for the requirements of a specific arrangement.

Under paragraph (4), remuneration derived by an individual from the performance of labor or personal serv-

ices performed as an employee aboard ships or aircraft operated by a resident of one Contracting State in international traffic will, notwithstanding paragraph (2), be exempt from tax by the other Contracting State if such individual (even if a resident of a State other than a Contracting State) is a member of the regular complement of the ship or aircraft.

ART. 16. PRIVATE PENSIONS AND ANNUITIES

Except as provided in Article 18 (Governmental Functions), pensions and other similar remuneration paid to an individual in consideration of past employment will be taxable under paragraph (1) only in the Contracting State of which he is a resident. Thus, private pensions and similar remuneration derived from sources within one Contracting State by an individual resident of the other Contracting State in consideration of past employment are exempt from tax in the first Contracting State. The term "pensions and other similar remuneration" is defined in paragraph (4) as periodic payments (other than social security payments in Article 17 (Social Security Payments)) made by reason of retirement or death in consideration for services rendered, or by way of compensation for injuries received in connection with past employment.

Paragraph (2) provides that alimony and annuities paid to an individual resident of a Contracting State will be taxable only in that Contracting State. The term "annuities" is defined in paragraph (5) as a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than for services rendered).

The term "alimony" is defined in paragraph (6) as periodic payments made pursuant to a decree of divorce or compulsory support, separate maintenance agreement, or support or separation agreement which are taxable to the recipient under the internal laws of the Contracting State of which he is a resident. Thus, the term "alimony" would not include a payment which would not be taxable to the recipient under the laws of the Contracting State in which he is a resident even though such payment is made pursuant to a decree of divorce or of separate maintenance. The explicit reference to a decree of compulsory support does not appear in prior United States conventions, but is consistent with section 71 of the Code.

Paragraph (3) provides that a resident of one Contracting State who receives child support payments from a resident of the other Contracting State will be exempt from tax on such payments in both Contracting States. The term "child support payments" is defined in paragraph (7) as periodic payments for the support of a minor child made pursuant to a decree of divorce, separate maintenance agreement, or support or separation agreement.

The exemptions provided by this article for pensions and other similar remuneration, alimony, annuities and child support payments are subject to the saving clause of paragraph (3) of Article 4 (General Rules of Taxation). Therefore, individuals who are citizens or residents of a Contracting State may be taxed by that Contracting State without regard to this article.

ART. 17. SOCIAL SECURITY PAYMENTS

This article provides that social security payments and other public pensions, e.g., railroad retirement benefits, paid by one Contracting State to an individual who is a resident of the other Contracting State will be exempt from tax in both Contracting States. Payments described in Article 18 (Governmental Functions) are not covered by this article.

Under paragraph (2) of Article 28 (Termination), this article may be terminated by either Contracting State at any time after the Convention enters into force.

ART. 18. GOVERNMENTAL FUNCTIONS

Under this article, wages, salaries, and similar remuneration, including annuities or similar benefits, paid from public funds of one Contracting State to a citizen of that Contracting State for labor or personal services performed as an employee of the national government of that Contracting State, or any agency thereof, in the discharge of functions of a governmental nature will be exempt from tax by the other Contracting State.

In order to avoid a potential conflict as to what constitutes governmental functions, the second sentence of this article provides that labor or personal services performed by a citizen of one Contracting State shall be treated by the other Contracting State as performed in the discharge of governmental functions if such labor or personal services would be treated under the internal laws of both Contracting State as so performed. Thus, compensation paid in connection with industrial or commercial activity is treated the same as compensation received from a private employer. This article does not include remuneration paid by a political subdivision or a local authority thereof within the exemption.

If the citizen becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this article. See paragraphs (3) and (4)(b) of Article 4 (General Rules of Taxation).

ART. 19. TEACHERS

Paragraph (1) provides that, if a resident of one Contracting State is invited by the other Contracting State, a political subdivision or local authority thereof, or by a university or other recognized educational institution in that other Contracting State to come to that other Contracting State for a period not expected to exceed two years for the purpose of teaching or engaging in research, or both, at a university or other recognized educational insti-

tution, and if such resident comes to that other Contracting State primarily for such purpose, his income from personal services for teaching or research at the university or educational institution will be exempt from tax by that other Contracting State for a period not exceeding two years from the date of his arrival in that other Contracting State.

Since a temporary visit may be of such a duration that an individual may lose his status as a resident of the Contracting State of which he was a resident at the time he became eligible for the benefits of this article, the individual need only be a resident of such Contracting State at the beginning of his visit. However, if the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this article. See paragraphs (3) and (4)(b) of Article 4 (General Rules of Taxation). If the individual's visit exceeds a period of two years from the date of his arrival, the exemption applies only to the income received by the individual before the expiration of such two year period.

The article does not apply to income from research undertaken not in the public interest but primarily for the private benefit of a specific person or persons.

ART. 20. STUDENTS AND TRAINEES

Paragraph (1) provides that an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for the primary purpose of studying at a university or other recognized educational institution, securing training required to qualify him to practice a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization, will be exempt from tax by that other Contracting State for a period not exceeding five taxable years from the date of his arrival in that other Contracting State on:

(1) Gifts from abroad for the purpose of his maintenance, education, study, research, or training;

(2) The grant, allowance, or award; and

(3) Income from personal services performed in the other Contracting State not in excess of $2,000 or its equivalent in Romanian lei for any taxable year.

Under paragraph (2), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein as an employee of, or under contract with, a resident of the first-mentioned Contracting State, for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned Contracting State or other than a person related to such resident, or studying at a university or other recognized educational institution in that other Contracting State, will be exempt from tax by that other Contracting State on income from personal services not in excess of $5,000 or its equivalent in Romanian lei for a period not exceeding one year.

Under paragraph (3), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for a period not exceeding one year, as a participant in a program sponsored by the other Contracting State, for the primary purpose of training, research, or study, will be exempt from tax by the other Contracting State with respect to his income from personal services in respect of such training, research, or study performed in that other Contracting State in an aggregate amount not in excess of $10,000 or its equivalent in Romanian lei.

The first sentence of paragraph (4) provides that the benefits provided in paragraph (1) and the benefits provided under Article 19 (Teachers), when taken together, may extend only for such period of time, not to exceed five taxable years from the date of the individual's arrival, as may reasonably or customarily be required to effectuate the purpose of the visit. The second sentence of paragraph (4) makes it clear that the benefits provided by Article 19 (Teachers) will not be available to an individual if, during the immediately preceding period, the individual enjoyed the benefits provided by paragraph (1).

If an individual qualifies for the benefits of more than one of the provisions of Articles 19 (Teachers) and 20 (Students and Trainees), such individual may choose the most favorable provision but may not claim the benefits of more than one provision in any taxable year as a means of avoiding the limitations provided. Thus, for example, an individual who comes to the other Contracting State for the primary purpose of studying may be able to qualify under either paragraph (2) or (3). However, he cannot combine the maximum exclusion limits in those two paragraphs to exclude $15,000 during the taxable year. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this article. See paragraphs (3) and (4)(b) of Article 4 (General Rules of Taxation).

ART. 21. RELIEF FROM DOUBLE TAXATION

In order to avoid double taxation each Contracting State agrees in this article to provide to its citizens or residents a credit against its taxes for taxes paid by such persons to the other Contracting State. The United States agrees to allow a United States citizen or resident as a credit against United States tax an appropriate amount of Romanian tax in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to

time without changing the principles of paragraph (1)). The credit will not exceed the portion of United States tax which such citizen's or resident's net income (i.e., taxable income) from sources within Romania or on his income from sources outside of the United States bears to his entire net income for the same taxable year. This provision does not require the United States to maintain a per-country and overall limitation in the future so long as the general principle of a foreign tax credit remains in effect.

In computing the credit for U.S. purposes, the Romanian taxes referred to in paragraph (1)(a) of Article 1 (Taxes Covered) will be considered to be income taxes. Thus, for example, among the creditable Romanian taxes is the tax on enterprises other than mixed companies or state enterprises, including the tax on foreign commercial representatives—even though the tax applies to income imputed to the representative under a schedule based on the number of employees in the representative's office, and thus might not be creditable under section 901 of the Code. It is intended that any income of a resident of the United States which has been subject to such a tax by Romania in accordance with the Convention will be treated as income from Romanian sources.

This article also provides that Romania will allow its citizens and residents a credit, under its law, as it may be amended from time to time, against their Romanian tax for taxes paid to the United States. The language as to the tax credit to be allowed by Romania is generally parallel to the language with respect to the United States.

ART. 22. NONDISCRIMINATION

Paragraph (1) provides that a citizen of one Contracting State who is a resident of the other Contracting State shall not be subjected in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof. The determination whether there is more burdensome taxation is to be made by comparing the treatment of individuals who are in comparable positions. Thus, for example, a citizen of Romania who is a resident of the United States and who otherwise meets the requirements specified in section 911 of the Code would under this article be eligible for the benefits of section 911 even though not a citizen of the United States. On the other hand, just as a United States citizen who becomes a nonresident alien at any time during a taxable year or whose spouse is a nonresident alien at any time during a taxable year cannot file a joint return for that year, a Romanian citizen would not be entitled to joint return with his spouse if either is a nonresident alien at any time dur the taxable year.

Paragraph (2) provides that one Contracting State may not impose more burdensome taxes on residents who are citizens of the other Contracting State or on permanent establishments of residents of the other Contracting State than it generally imposes on citizens or permanent establishments of residents of third States carrying on the same activities.

Paragraph (3) prohibits one Contracting State from subjecting a corporation of such Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than those applicable to corporations of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of a third State.

The criterion in paragraphs (2) and (3) is in terms of residents of third States, or permanent establishments of and corporations owned or controlled by, residents of third States, rather than to citizens or residents of that Contracting State, because the Romanian taxation of other foreign businesses is a more relevant comparison than Romanian taxation of domestic businesses which are frequently state enterprises. However, paragraphs (2) and (3) do not require a Contracting State to grant to citizens or permanent establishments of residents of the other Contracting State, or to corporations owned or controlled by such residents, tax benefits granted by special agreements, e.g., bilateral income tax conventions, to citizens or residents of a third State or corporations owned or controlled by such residents.

Under paragraph (3) of Article 1 (Taxes Covered), the provisions of this article extend to all taxes of every kind whether imposed at the national, state, or local level.

ART. 23. MUTUAL AGREEMENT PROCEDURE

When a resident of one Contracting State considers that action of one or both Contracting States results or will result for him in taxation not in accordance with the Convention, such resident may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident or citizen. A resident of a Contracting State need not, although it is anticipated that in the normal situation he will, exhaust his other administrative or judicial remedies prior to resorting to the use of the mutual agreement procedure. If the claim is considered to have merit by the competent authority, that competent authority must endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation not in accordance with the Convention.

Paragraph (2) requires the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may agree to the same attribution of industrial or com-

mercial profits to a resident of one Contracting State and its permanent establishment situated in the other Contracting State; the same allocation of income, deductions, credits, or allowances between a resident of one Contracting State and a related person and to the readjustment of taxes imposed by each Contracting State to reflect such allocation; the same determination of the source of particular items of income; and the same characterization of particular items of income.

Under paragraph (3), in implementing the provisions of this article, the competent authorities may communicate with each other directly and, when advisable, meet together for an exchange of opinions.

Under paragraph (4), in cases in which the competent authorities reach an agreement, taxes will be imposed on such income, and refund or credit of taxes allowed, by the Contracting States in accordance with such agreement. This permits the issuance of a refund or credit notwithstanding procedural barriers otherwise existing under a Contracting State's law, such as the statute of limitations.

Art. 24. Exchange of Information

Paragraph (1) provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information necessary for carrying out the provisions of the Convention or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which the Convention applies. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes.

Under paragraph (2) information exchanged must be treated as secret except that it may be disclosed to any person charged with, or made part of a public record with respect to, the assessment, collection, enforcement of, or litigation with respect to, the taxes to which the Convention applies. Thus, disclosure is not prohibited as a part of a public proceeding before a court or administrative body.

The article provides two limitations on what kind of information can be exchanged. Under paragraph (1), the information must be of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes. Thus, a Contracting State requested to furnish information will use the standard it uses in the enforcement of its own laws by its administrative and judicial authorities, treating the tax of the Contracting State with respect to which the request relates as if it were a tax of the Contracting State requested to furnish the information and were being imposed by such Contracting State. Under paragraph (3), no information will be exchanged which would be contrary to public policy.

Under paragraph (4), depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings) shall be provided by the competent authority of a Contracting State if specifically requested by the competent authority of the other Contracting State to the same extent that such depositions and documents can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes. The standard to be used by a Contracting State, when requested to provide such depositions and documents, is the same standard as described above under paragraph (1).

Although implicit in any tax convention providing for exchange of information, paragraph (5) provides that any depositions and evidence which may be furnished in accordance with this article shall not be withheld by reason of any doctrine of law under which international judicial assistance is not accorded in tax matters.

Paragraph (6) provides for the exchange of information on either a routine basis or on request with reference to particular cases. The competent authorities may agree on the list of information to be furnished on a routine basis.

Art. 25. Members of Diplomatic Missions and Consular Offices

This article provides that nothing in the Convention will affect the fiscal privileges of members of diplomatic missions and consular offices under the general rules and norms of international law or under the provisions of special agreements. This is merely a special case of the general rule provided in paragraph (2) of Article 4 (General Rules of Taxation).

Art. 26. Assistance in Collection

This article provides for mutual assistance in the collection of taxes where required to insure that the benefits of the Convention will only be extended to persons entitled to such benefits. It does not in any way affect rights of residents of the Contracting States under the Convention.

Paragraph (1) provides that each Contracting State will endeavor to collect on behalf of the other Contracting State such taxes imposed by that other Contracting State as will ensure that any exemption or reduced rate of tax granted under the Convention will not be enjoyed by persons not entitled to those benefits. However, paragraph (2) makes clear that this does not impose on a Contracting State the obligation to carry out measures at variance with the laws or administrative practices of either Contracting State with respect to collection of its own taxes.

Art. 27. Entry Into Force

This article provides that the Convention is subject to ratification and for the exchange of instruments of ratification. The Convention will enter into force one month after the date of exchange of such instruments of ratification. The provisions of the Convention shall first have effect with respect to income of calendar years or taxable years beginning (or in the case of

taxes payable at source, payments made) on or after January 1, 1974. It is intended for purposes of this article and Article 28 (Termination) that the reference to calendar years applies only to cases where the taxable year is the calendar year.

ART. 28. TERMINATION

Paragraph (1) provides that the Convention will continue in effect indefinitely, but that it may be terminated by either Contracting State at any time after five years from the date it enters into force. A Contracting State seeking to terminate the Convention must give notice at least six months before the end of the calendar year through diplomatic channels. If the Convention is terminated, such termination will be effective with respect to income of calendar years or taxable years beginning (or, in the case of taxes payable at source, payments made) on or after January 1 next following the expiration of the six month period.

Under paragraph (2), the provisions of Article 17 (Social Security Payments) may be terminated by either Contracting State at any time after the Convention enters into force by prior notice given through diplomatic channels.

United States—United Kingdom Income Tax Convention Not Applicable to Southern Rhodesia or to Yemen

In response to inquiries the Treasury Department announced that the income tax convention between the United States and the United Kingdom, as extended in 1959 to Southern Rhodesia (then part of the Federation of Rhodesia and Nyasaland) [1960-2 C.B. 653] has not applied to Southern Rhodesia since January 1, 1974. The extension of the U.S.-U.K. tax treaty to Southern Rhodesia was terminated by the United States, effective January 1, 1974, by diplomatic note to the Government of the United Kingdom in accordance with the procedure established in the convention.

The Treasury also announced that the income tax convention between the United States and the United Kingdom as extended in 1959 to the Peoples Democratic Republic of Yemen (then part of Aden) has been inapplicable to the People's Democratic Republic of Yemen since that country became independent on November 30, 1967. The government of Yemen did not take the necessary steps to affirm that it was assuming the obligation of the income tax convention. The convention is therefore considered inapplicable to the People's Democratic Republic of Yemen by the United States.

(Filed by the Office of the Federal Register on July 28, 1976, 8:45 a.m., and published in the issue of the Federal Register for July 29, 1976, 41 F.R. 31578)

Subpart B.—Legislation and Related Committee Reports

Public Law 94-273 94th Congress, S. 2445[1] April 21, 1976

An Act to provide permanent changes in laws necessary because of the October-September fiscal year.

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 "Fiscal Year Adjustment Act."

SEC. 2. The following provisions of law are amended by deleting "June," wherever it appears, and inserting "September" in lieu thereof:

* * * * *

(7) section 2 of the Land and Water Conservation Fund Act, as amended (16 U.S.C. 4601-5) [Pub. L. 88-578, 1964-2 C.B. 654];

* * * * *

(17) section 402 of the Act of November 13, 1966 (31 U.S.C. 757f) [Pub. L. 89-809, 1966-2 C.B. 656], except for the reference to June 30, 1967;

* * * * *

SEC. 3. The following provisions of law are amended by deleting "July," wherever it appears, and inserting "October" in lieu thereof—

* * * * *

(4) sections 5(b) and 201(b) of the Land and Water Conservation Fund Act (16 U.S.C. 4601-7(b) and 4601-11(b)) [Pub. L. 88-578, 1964-2 C.B. 654];

* * * * *

SEC. 5. The following provisions of law are amended by deleting "December," wherever it appears, and inserting "March" in lieu thereof—

* * * * *

(4) section 103(a) of the Act of June 6, 1972 (31 U.S.C. 1203(a)) [Pub. L. 92-310, 1972-2 C.B. 670];

* * * * *

SEC. 12. The following provisions of law are amended by deleting "March" and inserting "June" in lieu thereof—

* * * * *

(2) section 105(a)(2) of the Act of October 20, 1972 (31 U.S.C. 1224(a)(2)) [Pub. L. 92-512, 1972-2 C.B. 684]; and

* * * * *

SEC. 18. Section 209(e)(1) of the Highway Revenue Act of 1956 (23 U.S.C. 120 note) [Pub. L. 627, 1956-2 C.B. 1150], is amended by deleting "March" and "June 30" and inserting "June" and "September 30," respectively, in lieu thereof.

* * * * *

SEC. 38. Sections 6(a)(1)(D) and (E) of the Alaska Native Claims Settlement Act (43 U.S.C. 1605) [Pub. L. 92-203, 1972-1 C.B. 490] are amended to read as follows:

"(D) $40,000,000 during the period beginning July 1, 1976, and ending September 30, 1976; and

"(E) $30,000,000 during each of the

[1] This publication of the law is restricted to excerpts involving tax matters; Senate Report No. 94-469 and House Report No. 94-1000 are not published.

next five fiscal years, for transfer to the Alaska Native Fund in the fourth quarter of each fiscal year.".

* * * * *

SEC. 47. Subsection (c) of section 5008 of the Internal Revenue Code of 1954 (26 U.S.C. 5008(c)) is amended by striking "fiscal year" each place it appears (including in the schedule contained in paragraph (3)(A)) and inserting in lieu thereof "computation year."

* * * * *

Approved April 21, 1976.

Public Law 94-274
94th Congress, S. 2444[1]
April 21, 1976

An Act to provide for the orderly transition to the new October 1 to September 30 fiscal year.

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 "Fiscal Year Transition Act."

* * * * *

TITLE II

SEC. 201. The period of July 1, 1976, through September 30, 1976, shall be treated as a fiscal year for the purpose of the following provisions of law:

* * * * *

(14) section 7652(b) of the Internal Revenue Code of 1954 (26 U.S.C. 7652);

* * * * *

(35) section 401 of the Act of December 31, 1970 (31 U.S.C. 1033) [Pub. L. 91-614, 1971-1 C.B. 533];

* * * * *

SEC. 205. The period of July 1, 1976, through September 30, 1976, shall be treated as part of the fiscal year beginning October 1, 1976, for the purposes of the following provisions of law:

* * * * *

(15) section 103 of the Act of June 6, 1972 (31 U.S.C. 1203) [Pub. L. 92-310, 1972-2 C.B. 670];

* * * * *

(16) section 105(a)(2) of the Act of October 20, 1972 (31 U.S.C. 1224(a)(2)) [Pub. L. 92-512, 1972-2 C.B. 684];

* * * * *

(18) section 413 of the Domestic Volunteer Service Act of 1973 (42 U.S.C. 5053) [Pub. L. 93-113, 1973-2 C.B. 441];

* * * * *

Approved April 21, 1976.

Public Law 94-280
94th Congress, H. R. 8235[1]
May 5, 1976

An Act to authorize appropriations for the construction of certain highways in accordance with title 23 of the United States Code, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

* * * * *

TITLE III—EXTENSION OF HIGHWAY TRUST FUND AND CERTAIN RELATED PROVISIONS

* * * * *

SEC. 303. POSTPONEMENT OF CERTAIN EXCISE TAX REDUCTIONS

(a) The following provisions of the Internal Revenue Code of 1954 are amended by striking out "1977" each place it appears and inserting in lieu thereof "1979":

(1) Section 4041(c)(3) relating to rate of tax on fuel for noncommercial aviation).

(2) Section 4041(e) (relating to rate reduction).

(3) Section 4061(a)(1) (relating to imposition of tax on trucks, buses, etc.).

(4) Section 4061(b)(1) (relating to imposition of tax on parts and accessories).

(5) Section 4071(d) (relating to imposition of tax on tires and tubes).

(6) Section 4081(b) (relating to imposition of tax on gasoline).

(7) Section 4481(a) (relating to imposition of tax on use of highway motor vehicles).

(8) Section 4481(e) (relating to period tax in effect).

(9) Section 4482(c)(4) (defining taxable period).

(10) Section 6156(e)(2) (relating to installment payments of tax on use of highway motor vehicles).

(11) Section 6421(h) (relating to tax on gasoline used for certain nonhighway purposes or by local transit systems).

(b) Section 6412(a)(2) of such Code (relating to floor stocks refunds) is amended—

(1) by striking out "1977" each place it appears and inserting in lieu thereof "1979"; and

(2) by striking out "1978" each place it appears and inserting in lieu thereof "1980".

Approved May 5, 1976.

House of Representatives
Report No. 94-716
1st Session

[Bracketed numerals indicate official report page numbers]

FEDERAL-AID HIGHWAY ACT OF 1975

December 11, 1975

Mr. Jones of Alabama, from the Committee on Public Works and Transportation, submitted the following report together with supplemental,

[1] This publication of the law is restricted to excerpts involving tax matters; Senate Report No. 94-468 and House Report No. 94-1001 are not published.

[1] This publication of the law and House Report No. 94-716, this page, is restricted to excerpts involving tax matters; Senate Report No. 94-485 and Conference Reports No. 94-1017 and 94-741 are not published.

minority, and additional views to accompany H.R. 8235.[1]

The Committee on Public Works and Transportation, to whom was referred the bill (H.R. 8235) to authorize appropriations for the construction of certain highways in accordance with title 23 of the United States Code, and for others purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

* * * * *

[102] TITLE III—EXTENSION OF HIGHWAY TRUST FUND AND REVENUES FOR TWO YEARS

* * * * *

II. General Statement

A. PRESENT LAW

Under present law, a series of highway user excise taxes are covered into the Highway Trust Fund: the manufacturers taxes on gasoline for highway use, lubricating oil, trucks and buses, truck and bus parts, and tires, tubes and tread rubber for highway use; the tax on use of heavy highway motor vehicles; and the retailers tax on diesel and special fuels for highway use.[2] These taxes in the fiscal year 1977 are expected to raise approximately $6.3 billion in revenue for the trust fund.

The trust fund is scheduled to expire after September 30, 1977; that is, tax liabilities arising after that date for the taxes mentioned above are to be paid into the general fund rather than the trust fund. However, taxes collected after September 30, 1977, on account of these pre-October 1977 liabilities will continue to be paid into the fund for 9 months after the basic expiration date; that is, until June 30, 1978. The balance in the fund can continue to be spent for highway trust fund purposes until September 30, 1977.

In addition, as is indicated in table 1, as of the same date, all of the taxes mentioned above (except the tax on lubricating oil) are sched-[103]uled to be reduced or eliminated. The taxes on rubber and on the use of heavy highway motor vehicles are to expire on that date; the remaining taxes are to be retained at lower levels which, in the aggregate, are expected to produce about 40 percent as much revenue as the taxes would produce at their present rates.

[1] Public Law 94-280, page 518.

[2] The Airport and Airway Revenue Act of 1970 created the Airport and Airway Trust Fund and covered into it the manufacturers and retailers taxes on aviation gasoline, the manufacturers taxes on tires and tubes of the types used on aircraft, and the retailers taxes on aviation fuel, as well as the taxes on transportation by air and on use of civil aircraft. The Land and Water Conservation Act of 1965 created the Land and Water Conservation Fund and required that the taxes on special fuels and gasoline used as motorboat fuel be transferred to that fund from the Highway Trust Fund.

TABLE 1.—EXCISE TAXES ALLOCATED TO THE HIGHWAY TRUST FUND

Tax (section of Internal Revenue Code)	Present tax rate	Tax rates effective Oct. 1, 1977[1]
Retailers: Diesel and special motor fuels (sec. 4041)	4 cents per gallon	1½ cents per gallon.
Manufacturers:		
Gasoline (sec. 4081)	do	Do.
Lubricating oil for highway use (sec. 4091)	6 cents per gallon	6 cents per gallon.
Trucks, buses, trailers (sec. 4061(a))	10 percent of manufacturers price	5 percent of manufacturers price.
Truck parts (sec. 4061(b))	8 percent of manufacturers price	Do.
Tires for highway use (sec. 4071(a)(1))[2]	10 cents per pound	5 cents per pound.
Tubes (sec. 4071(a)(3))	do	9 cents per pound.
Tread rubber (sec. 4071(a)(4))	5 cents per pound	None.
Other: Use tax on highway vehicles in excess of 26,000 lbs taxable gross weight (sec. 4481).	$3 per 1,000 lbs per year	Do.

[1] At that time, revenues are scheduled to go into the general fund.

[2] Sec. 4071 also imposes a tax of 5 cents per pound for nonhighway tires, except for a tax of 1 cent per pound on "laminated tires" (not used on highway vehicles). Revenues from these 2 taxes go into the trust fund and are not scheduled for a change in rate on Oct. 1, 1977.

Under present law, the Highway Trust Fund is required periodically to pay into the Land and Water Conservation Fund (an earmarking of moneys in the general fund) amounts estimated to be equivalent to the taxes on gasoline and special motor fuels used as fuel in motorboats. Also, the Highway Trust Fund is required to reimburse the general fund of the Treasury for refunds, etc., of taxes for gasoline, lubricating oil, and special fuels used on farms, or used for nonhighway purposes, as well as for use by certain local transit.[3] Further, the Airport and Airway Revenue Act of 1970 requires the Highway Trust Fund to pay into the Airport and Airway Trust Fund amounts estimated to be equivalent to the taxes on aviation gasoline and special fuels, and the taxes on tires and tubes used on aircraft.

[3] In addition, the Highway Trust Fund is to reimburse the general fund of the Treasury for floor stocks refunds made on account of the reductions in tax to become effective on October 1, 1977.

B. REASONS FOR EXTENSION

It has become evident to the Committee on Ways and Means that the Interstate Highway System cannot be completed by the present expiration date of the Highway Trust Fund. Testimony from the Committee on Public Works and Transportation indicates that the likely completion date of the Interstate System will be about 1988. At the same time, the Committee on Ways and Means realizes that many would like to see substantial

modifications made in the trust fund, although it has not as yet had time to study and reach conclusions as to what these modifications should be.

Insofar as the funding of the Interstate System and other programs is concerned, the termination of the trust fund in 1977 already is a matter of concern for Congress because of the timing involved in the authorization and apportionment processes. At the present time, [104] consideration is being given to the authorizations for appropriations for the transition quarter and fiscal years 1977 and 1978. The Federal Highway Administration is awaiting these authorizations in order to make the apportionment among the States for fiscal year 1977. According to the Committee on Public Works and Transportation, the Highway Trust Fund needs to be extended for 2 years in order to provide the funding for the 2-year highway authorization in titles I and II of this bill. This is because of the advance funding of the obligations for highway construction, and the need for the trust fund receipts to be available to finance these authorizations and obligations as the actual payments come due in subsequent fiscal years.

As a result, it is clear that if the current construction and safety programs of the States are not to be interrupted, a decision needs to be made expeditiously as to whether the Highway Trust Fund is to be extended beyond the 1977 date. However, since there has not yet been an opportunity to study and reach conclusions as to modifications which are sought, the Committee on Ways and Means believes that only a temporary extension of short duration should be provided for the fund. Because of these considerations, the committee has extended the Highway Trust Fund, but only for 2 years in order to provide time for possible modifications to be reviewed.

The revenues of the Highway Trust Fund are also extended for another 2 years at the present tax rates in order to provide funding for the additional 2-year period. As indicated in table 2, the extension of the trust fund taxes from October 1, 1977, through September 30, 1979, are estimated to yield additional revenue of about $13.3 billion for the trust fund. Approximately 40 percent of this amount, or $5.4 billion, would otherwise have been general fund revenues in the absence of this title.

C. EXPLANATION OF PROVISIONS

For the reasons indicated above, title III of the bill extends the Highway Trust Fund for 2 years, from September 30, 1977, through September 30, 1979. It also postpones for 2 years those tax rate reductions which had been scheduled to take effect at the expiration of the trust fund under present law in 1977 and postpones for 2 years the transfer of other tax revenues back to the general fund. Finally, it extends for 2 years the provisions dealing with payments out of the trust fund (including payments to the Land and Water Conservation Fund).

[105] TABLE 2.—NET HIGHWAY TRUST FUND REVENUES, FOR FISCAL YEAR 1975 (ACTUAL) AND FOR YEARS 1976-79 AND TRANSITION QUARTER (PROJECTED)

[Dollar amounts in millions; fiscal years]

Tax	1975 (actual)	1976 [1]	3-mo. period	1977	1978 [2]	1979
A. AMOUNTS						
Gasoline	$3,938	$3,904	$1,036	$3,939	$4,122	$4,279
Diesel fuel	402	370	113	459	484	507
Tires, tubes	797	566	215	827	842	858
Trucks, buses	602	375	140	578	585	595
Truck parts	143	106	45	173	183	193
Truck use	221	08	100	214	216	218
Lubricating oil	84	59	27	91	94	98
Total	6,188	5,588	1,676	6,281	6,526	6,748
B. PERCENTAGE DISTRIBUTION						
Gasoline	63.6	69.9	61.8	62.7	63.2	63.4
Diesel fuel	6.5	6.6	6.7	7.3	7.4	7.5
Tires, tubes	12.9	10.1	12.8	13.2	12.9	12.7
Trucks, buses	9.7	6.7	8.4	9.2	9.0	8.8
Truck parts	2.3	1.9	2.7	2.8	2.8	2.9
Truck use	3.6	3.7	6.0	3.4	3.3	3.2
Lubricating oil	1.4	1.1	1.6	1.4	1.4	1.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

[1] The estimate for fiscal 1976 is as revised from the amounts appearing in the fiscal 1976 budget. The difference between the 1976 budget figure ($5.972 billion) and the current estimate results primarily from a downward correction to trust fund receipts for fiscal 1976 because of overestimates for fiscal 1975.

[2] Of the amounts for fiscal years 1978 and 1979, the 2-yr extension of the trust fund involves an additional $7.9 billion in revenue over present law; the other $5.4 billion under the scheduled reduction in rates as of Oct. 1, 1977 (under present law) would go into the general fund in the absence of this extension of the trust fund.

Source: Department of Treasury and Department of Transportation, Federal Highway Administration.

More specifically, the following provisions are extended by this title:

Highway Trust Fund

(1) Present law's appropriation to the trust fund of amounts equivalent to the listed excise taxes received by the Internal Revenue Service before October 1, 1977, is changed to an appropriation of amounts so received before October 1, 1979. The excise taxes to which this applies are the retailers taxes on diesel fuel and special motor fuels, the manufacturers taxes on gasoline, lubricating oil, tires and tubes, tread rubber, trucks and buses, and truck and bus parts, and the use tax on highway motor vehicles weighing over 26,000 pounds.

(2) Under present law, the trust fund also is to receive amounts equal to the amount of those taxes which are received by the Internal Revenue Service after September 30, 1977, and before July 1, 1978, and which are attributable to tax liabilities incurred before Octo-[106]ber 1, 1977. The bill extends the 1977 dates to 1979 and the 1978 date to 1980. The effect of this is to allow 9 months for collection of pre-October 1979 liabilities for the listed taxes, the same procedure followed under present law with respect to 1977 liabilities.

(3) The requirement that the Secretary of the Treasury report to Congress by March 1 of each year on the condition and operation of the fund through the fiscal year 1978, is extended to require reports for the fiscal years 1979 and 1980.

(4) The provision making trust fund moneys available for Federal-aid highway expenditures before October 1, 1977, is extended to expenditures before October 1, 1979.

(5) The provision that the trust fund is to reimburse the general fund for refunds and credits for certain uses of gasoline, lubricating oil, and special fuels for periods ending before October 1, 1977, is extended to apply to periods ending before October 1, 1979. Reimbursements are to be made in the case of payments (under secs. 6420, 6421, 6424, and 6427 of the Internal Revenue Code) only for amounts paid by the Treasury before July 1, 1980. Present law limits such payments to those made before July 1, 1978.

(6) The provision that the trust fund reimburse the general fund for floor stocks refunds paid before July 1, 1978, on account of the present law's scheduled 1977 reductions in manufacturers taxes, is changed to apply to floor stocks refunds paid before July 1, 1980, on account of the 1979 tax reductions provided by this title.

Land and Water Conservation Fund

(1) The provision that the Land and Water Conservation Fund reimburse the general fund for refunds and credits for certain uses of gasoline for periods ending before October 1, 1977, is extended to apply to periods ending before October 1, 1979. Reimbursements are to be made in the case of payments under section 6421 of the code only for amounts paid by the Treasury before July 1, 1980. Present law limits such payments to those made before July 1, 1978.

(2) The provision that the Land and Water Conservation Fund reimburse the general fund for floor stocks refunds paid before July 1, 1978, on account of the gasoline tax reduction in 1977, is changed to apply to floor stocks refunds paid before July 1, 1980, on account of the 1979 tax reduction.

Postponement of Excise Tax Reduction

(1) The Airport and Airway Revenue Act of 1970 imposed a retailers tax on gasoline sold for use or used in aircraft in noncommercial aviation. Under present law, that tax is to be 3 cents per gallon until September 30, 1977, and 5½ cents per gallon thereafter (until June 30, 1980), so that the total tax on aviation gasoline would be 7 cents per gallon both before and after September 30, 1977. The bill postpones that changeover date to September 30, 1979.

(2) Under present law, the taxes on special fuels and diesel fuels are to be reduced from 4 cents per gallon to 1½ cents per gallon on and after October 1, 1977. The bill postpones that reduction to October 1, 1979.

(3) Present law provides that the truck and bus tax is to be reduced from 10 percent of the manufacturers' sales price to 5 percent on and [107] after October 1, 1977. The bill postpones that reduction until October 1, 1979.

(4) Present law provides that the truck and bus parts and accessories tax is to be reduced from 8 percent of the manufacturer's sales price to 5 percent on and after October 1, 1977. The bill postpones that reduction until October 1, 1979.

(5) Present law provides that on and after October 1, 1977, the highway vehicle tire tax is to be reduced from 10 cents per pound to 5 cents per pound; the inner tube tax is to be reduced from 10 cents per pound to 9 cents per pound; and the tread rubber tax of 5 cents per pound is to expire. The bill postpones the date to October 1, 1979.

(6) Present law provides that the gasoline tax is to be reduced from 4 cents per gallon to 1½ cents per gallon on and after October 1, 1977. The bill postpones this reduction to October 1, 1979.

(7) Present law provides that the tax on use of heavy motor vehicles (over 26,000 pounds taxable gross weight) is to apply only to use before October 1, 1977. The bill extends the tax to use before October 1, 1979.

(8) Present law provides special rules and definitions for the heavy vehicle use tax for the period beginning on July 1, 1977, and ending on September 30, 1977. The bill makes those rules and definitions applicable, instead, to the July 1 through September 30, 1979, period.

(9) Present law provides that the privilege of paying the heavy vehicle use tax in installments is not to apply to tax liabilities incurred in July, August, or September of 1977. The bill

changes this to July, August, or September of 1979.

(10) Present law provides that the special refund provisions of section 6421 (relating to gasoline used for certain nonhighway purposes or by local transit systems) shall not apply with respect to gasoline purchased after September 30, 1977. The bill extends the application of section 6421 to gasoline purchased before October 1, 1979.

(11) Present law provides for floor stocks refunds in the case of the manufacturers taxes on trucks and buses, tires, tubes, tread rubber, and gasoline that are scheduled to be reduced on October 1, 1977. Under the floor stocks refund provision, the dealer must submit a claim to the manufacturer before January 1, 1978, and the manufacturer must file a claim for refund with the Internal Revenue Service by March 31, 1978, and also by that latter date the manufacturer must have either reimbursed the dealer for the tax or obtained the dealer's written consent to the refund.

The bill changes the tax reduction date to October 1, 1979, the date for dealer submission of claims to the manufacturer to January 1, 1980, and the date for the manufacturer to file his claim for refund and to have reimbursed the dealer and obtained the dealer's consent to March 31, 1980.

III. Effect of the Revenues of the Title and Vote of the Committee on Ways and Means in Reporting the Title

In compliance with clause 7 of the rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect on the revenues of title III of this bill. The Committee on [108] Ways and Means estimates that title III of the bill will have no effect on tax liabilities for fiscal 1976, the transition quarter, and fiscal 1977. The Treasury Department agrees with this statement.

* * * * *

Public Law 94-283
94th Congress, S. 3065 [1]
May 11, 1976

An act to amend the Federal Election Campaign Act of 1971 to provide that members of the Federal Election Commission shall be appointed by the President, by and with the advice and consent of the Senate, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

Section 1. This Act may be cited as the "Federal Election Campaign Act Amendments of 1976".

TITLE I—AMENDMENTS TO FEDERAL ELECTION CAMPAIGN ACT OF 1971

* * * * *

TECHNICAL AND CONFORMING AMENDMENTS

Sec. 115. * * *

* * * * *

(c)(1) Section 9002(3) of the Internal Revenue Code of 1954 (defining Commission) is amended by striking out "310(a)(1)" and inserting in lieu thereof "309(a)(1)".

(2) Section 9032(3) of the Internal Revenue Code of 1954 (defining Commission) is amended by striking out "310(a)(1)" and inserting in lieu thereof "309(a)(1)".

* * * * *

TITLE III—AMENDMENTS TO INTERNAL REVENUE CODE OF 1954

ENTITLEMENT OF ELIGIBLE CANDIDATES TO PAYMENTS

Sec. 301. (a) Section 9004 of the Internal Revenue Code of 1954 (relating to entitlement of eligible candidates to payments) is amended by adding at the end thereof the following new subsections:

"(d) Expenditures From Personal Funds.—In order to be eligible to receive any payment under section 9006, the candidate of a major, minor, or new party in an election for the office of President shall certify to the Commission, under penalty of perjury, that such candidate will not knowingly make expenditures from his personal funds, or the personal funds of his immediate family, in connection with his campaign for election to the office of President in excess of, in the aggregate, $50,000. For purposes of this subsection, expenditures from personal funds made by a candidate of a major, minor, or new party for the office of Vice President shall be considered to be expenditures by the candidate of such party for the office of President.

"(e) Definition of Immediate Family.—For purposes of subsection (d), the term 'immediate family' means a candidate's spouse, and any child, parent, grandparent, brother, half-brother, sister, or half-sister of the candidate, and the spouses of such persons.".

(b) For purposes of applying section 9004 (d) of the Internal Revenue Code of 1954, as added by subsection (a), expenditures made by an individual after January 29, 1976, and before the date of the enactment of this Act shall not be taken into account.

PAYMENTS TO ELIGIBLE CANDIDATES; INSUFFICIENT AMOUNTS IN FUND

Sec. 302. (a) Section 9006 of the Internal Revenue Code of 1954 (relating to payments to eligible candidates) is amended by striking out subsection (b) thereof and by redesignating subsection (c) and subsection (d) as subsection (b) and subsection (c), respectively.

(b) Section 9006(c) of the Internal Revenue Code of 1954 (relating to insufficient amounts in fund), as redesignated by subsection (a), is

[1] This publication of the law is restricted to excerpts involving internal revenue matters; Senate Report No. 94-677, page 525; Conference Report No. 94-1057, page 525; House Report No. 94-917 is not published.

amended by adding at the end thereof the following new sentence: "In any case in which the Secretary or his delegate determines that there are insufficient moneys in the fund to make payments under subsection (b), section 9008(b)(3), and section 9037(b), moneys shall not be made available from any other source for the purpose of making such payments."

PROVISION OF LEGAL OR ACCOUNTING SERVICES

SEC. 303. Section 9008(d) of the Internal Revenue Code of 1954 (relating to limitation of expenditures) is amended by adding at the end thereof the following new paragraph:

"(4) PROVISIONS OF LEGAL OR ACCOUNTING SERVICES.—For purposes of this section, the payment, by any person other than the national committee of a political party (unless the person paying for such services is a person other than the regular employer of the individual rendering such services) of compensation to any individual for legal or accounting services rendered to or on behalf of the national committee of a political party shall not be treated as an expenditure made by or on behalf of such committee with respect to its limitations on presidential nominating convention expenses.".

REVIEW OF REGULATIONS

SEC. 304. (a) Section 9009(c) of the Internal Revenue Code of 1954 (relating to review of regulations) is amended—

(1) in paragraph (2) thereof, by inserting immediately after the first sentence thereof the following new sentences: "Whenever a committee of the House of Representatives reports any resolution relating to any such rule or regulation, it is at any time thereafter in order (even though a previous motion to the same effect has been disagreed to) to move to proceed to the consideration of the resolution. The motion is highly privileged and is not debatable. An amendment to the motion is not in order, and it is not in order to move to reconsider the vote by which the motion is agreed to or disagreed to."; and

(2) by adding at the end thereof the following new paragraph:

"(4) For purposes of this subsection, the term 'rule or regulation' means a provision or series of interrelated provisions stating a single separable rule of law.".

(b) Section 9039(c) of the Internal Revenue Code of 1954 (relating to review of regulations) is amended—

(1) in paragraph (2) thereof, by inserting immediately after the first sentence thereof the following new sentences: "Whenever a committee of the House of Representatives reports any resolution relating to any such rule or regulation, it is at any time thereafter in order (even though a previous motion to the same effect has been disagreed to) to move to proceed to the consideration of the resolution. The motion is highly privileged and is not debatable. An amendment to the motion is not in order, and it is not in order to move to reconsider the vote by which the motion is agreed to or disagreed to."; and

(2) by adding at the end thereof the following new paragraph:

"(4) For purposes of this subsection, the term 'rule or regulation' means a provision or series of interrelated provisions stating a single separable rule of law.".

QUALIFIED CAMPAIGN EXPENSE LIMITATION

SEC. 305. (a) Section 9035 of the Internal Revenue Code of 1954 (relating to qualified campaign expense limitation) is amended—

(1) in the heading thereof, by striking out "LIMITATION" and inserting in lieu thereof "LIMITATIONS";

(2) by inserting "(a) EXPENDITURE LIMITATIONS.—" immediately before "No candidate";

(3) by inserting immediately after "State Code" the following: ", and no candidate shall knowingly make expenditures from his personal funds, or the personal funds of his immediate family, in connection with his campaign for nomination for election to the office of President in excess of, in the aggregate, $50,000"; and

(4) by adding at the end thereof the following new subsection:

"(b) DEFINITION OF IMMEDIATE FAMILY.—For purposes of this section, the term 'immediate family' means a candidate's spouse, and any child, parent, grandparent, brother, half-brother, sister, or half-sister of the candidate, and the spouses of such persons.".

(b) The table of sections for chapter 96 of the Internal Revenue Code of 1954 is amended by striking out the item relating to section 9035 and inserting in lieu thereof the following new item:

"SEC. 9035. Qualified campaign expense limitations.".

(c) Section 9033(b)(1) of the Internal Revenue Code of 1954 (relating to expense limitation; declaration of intent; minimum contributions) is amended by striking out "limitation" and inserting in lieu thereof "limitations".

(d) For purposes of applying section 9035(a) of the Internal Revenue Code of 1954, as amended by subsection (a), expenditures made by an individual after January 29, 1976, and before the date of the enactment of this Act shall not be taken into account.

RETURN OF FEDERAL MATCHING PAYMENTS

SEC. 306. (a)(1) Section 9002(2) of the Internal Revenue Code of 1954 (defining candidate) is amended by adding at the end thereof the following new sentence: "The term 'candidate' shall not include any individual who has ceased actively to seek election to the office of President of the United States or to the office of Vice President of the United States, in more than one State.".

(2) Section 9003 of the Internal Revenue Code of 1954 (relating to

condition for eligibility for payments) is amended by adding at the end thereof the following new subsection:

"(d) WITHDRAWAL BY CANDIDATE.—In any case in which an individual ceases to be a candidate as a result of the operation of the last sentence of section 9002(2), such individual—

"(1) shall no longer be eligible to receive any payments under section 9006, except that such individual shall be eligible to receive payments under such section to defray qualified campaign expenses incurred while actively seeking election to the office of President of the United States or to the office of Vice President of the United States in more than one State; and

"(2) shall pay to the Secretary or his delegate, as soon as practicable after the date upon which such individual ceases to be a candidate, an amount equal to the amount of payments received by such individual under section 9006 which are not used to defray qualified campaign expenses.".

(b)(1) Section 9032(2) of the Internal Revenue Code of 1954 (defining candidate) is amended by adding at the end thereof the following new sentence: "The term 'candidate' shall not include any individual who is not actively conducting campaigns in more than one State in connection with seeking nomination for election to be President of the United States.".

(2) Section 9033 of the Internal Revenue Code of 1954 (relating to eligibility for payments is amended by adding at the end thereof the following new subsection:

"(c) TERMINATION OF PAYMENTS.—

"(1) GENERAL RULE.—Except as provided by paragraph (2), no payment shall be made to any individual under section 9037—

"(A) if such individual ceases to be a candidate as a result of the operation of the last sentence of section 9032(2); or

"(B) more than 30 days after the date of the second consecutive primary election in which such individual receives less than 10 percent of the number of votes cast for all candidates of the same party for the same office in such primary election, if such individual permitted or authorized the appearance of his name on the ballot, unless such individual certifies to the Commission that he will not be an active candidate in the primary involved.

"(2) QUALIFIED CAMPAIGN EXPENSES; PAYMENTS TO SECRETARY.—Any candidate who is ineligible under paragraph (1) to receive any payments under section 9037 shall be eligible to continue to receive payments under section 9037 to defray qualified campaign expenses incurred before the date upon which such candidate becomes ineligible under paragraph (1).

"(3) CALCULATION OF VOTING PERCENTAGE.—For purposes of paragraph (1)(B), if the primary elections involved are held in more than one State on the same date, a candidate shall be treated as receiving that percentage of the votes on such date which he received in the primary election conducted on such date in which he received the greatest percentage vote.

"(4) REESTABLISHMENT OF ELIGIBILITY.—

"(A) In any case in which an individual is ineligible to receive payments under section 9037 as a result of the operation of paragraph (1)(A), the Commission may subsequently determine that such individual is a candidate upon a finding that such individual is actively seeking election to the office of President of the United States in more than one State. The Commission shall make such determination without requiring such individual to reestablish his eligibility to receive payments under subsection (a).

"(B) Notwithstanding the provisions of paragraph (1)(B), a candidate whose payments have been terminated under paragraph (1)(B) may again receive payments (including amounts he would have received but for paragraph (1)(B)) if he receives 20 percent or more of the total number of votes cast for candidates of the same party in a primary election held after the date on which the election was held which was the basis for terminating payments to him.".

(c) The amendments made by this section shall take effect on the date of the enactment of this Act.

TECHNICAL AND CONFORMING AMENDMENTS

SEC. 307. (a) Section 9008(b)(5) of the Internal Revenue Code of 1954 (relating to adjustment of entitlements) is amended—

(1) by striking out "section 608(c) and section 608(f) of title 18, United States Code," and inserting in lieu thereof "section 320(b) and section 320(d) of the Federal Election Campaign Act of 1971"; and

(2) by striking out "section 608 (d) of such title" and inserting in lieu thereof "section 320(c) of such Act".

(b) Section 9034(b) of the Internal Revenue Code of 1954 (relating to limitations) is amended by striking out "section 608(c)(1)(A) of title 18, United States Code," and inserting in lieu thereof "section 320(b)(1)(A) of the Federal Election Campaign Act of 1971".

(c) Section 9035(a) of the Internal Revenue Code of 1954 (relating to expenditure limitations), as redesignated by section 305(a), is amended by striking out "section 608(c)(1)(A) of title 18, United States Code" and inserting in lieu thereof "section 320(b)(1)(A) of the Federal Election Campaign Act of 1971".

(d) Section 9004(a)(1) of the Internal Revenue Code of 1954 (relating to entitlements of eligible candidates to payments) is amended by striking out "608(c)(1)(B) of title 18, United States Code" and inserting in lieu thereof "320(b)(1)(B) of the Federal Election Campaign Act of 1971".

(e) Section 9007(b)(3) of the Internal Revenue Code of 1954 (relating to repayments) is amended by striking out "9006(d)" and inserting in lieu thereof "9006(c)".

(f) Section 9012(b)(1) of the Internal Revenue Code of 1954 (relating to contributions) is amended by striking out "9006(d)" and inserting in lieu thereof "9006(c)".

Approved May 11, 1976.

Senate Report No. 94-677 2d Session

[Bracketed numerals indicate official report page numbers]

FEDERAL ELECTION CAMPAIGN ACT AMENDMENTS OF 1976

Mr. Cannon, from the Committee on Rules and Administration, submitted the following report together with minority views to accompany S. 3065.[1]

The Committee on Rules and Administration, having considered an original bill to amend the Federal Election Campaign Act of 1971, as amended in 1974, to provide for its administration by a Federal Election Commission appointed in accordance with the requirements of the Constitution, and to amend certain other provisions of law relating to the financing and conduct of such campaigns, reports favorably thereon, and recommends that the bill do pass.

* * * * *

[3] SECTION-BY-SECTION ANALYSIS

* * * * *

[13] ENTITLEMENT OF ELIGIBLE PRESIDENTIAL CANDIDATES FOR PUBLIC FINANCING

Section 301 of the bill amends the public financing provisions of the Internal Revenue Code of 1954 by prohibiting a Presidential candidate who accepts public funds from expending more than $50,000 from his own personal funds or the funds of his immediate family in connection with his campaign.

PAYMENTS TO ELIGIBLE CANDIDATES

Section 302 of the bill would repeal that provision of section 9006 of the Internal Revenue Code of 1954 which provides for the Secretary of the Treasury to transfer excess amounts in the Presidential Election Campaign Fund back to the general fund of the Treasury, thus permitting such funds to accumulate for later use.

REVIEW OF REGULATIONS

Section 303 of the bill amends the public financing provisions of the Internal Revenue Code of 1954 relating to Congressional review of regulations promulgated under such provisions, to provide for a 15-legislative day or 30-calendar day period, whichever is later, during which a proposed rule or regulation can be disapproved, to conform with the same change made by section 109(b) of the bill.

ELIGIBILITY FOR PAYMENTS

Section 304 of the bill makes a clerical change in a provision of the Internal Revenue Code which refers to limitations modified by this Act.

QUALIFIED CAMPAIGN EXPENSE LIMITATION

Section 305 of the bill adds the limitation on the expenditure of personal funds to the General Provision relating to expenditure limitations in the public financing provisions of the Internal Revenue Code.

TECHNICAL AND CONFORMING AMENDMENTS

Section 306 of the bill makes a number of changes correcting cross references of the Internal Revenue Code to provisions of title 18 which, under the bill, are transferred to the Federal Election Campaign Act of 1971. Section 306 of the bill also amends Section 9008(d) of Title 26 of the Internal Revenue Code to provide that the payment of legal and accounting services rendered to or on behalf of a national committee of a political party shall not be treated as an expenditure made by or on behalf of such committee with respect to its limitations on Presidential nominating convention expenses.

* * * * *

Conference Report No. 94-1057 2d Session

[Bracketed numerals indicate official report page numbers]

FEDERAL ELECTION CAMPAIGN ACT AMENDMENTS OF 1976

Mr. Hays of Ohio, from the committee of conference, submitted the following conference report to accompany S. 3065.[1]

The committee of conference on the disagreeing votes of the two Houses on the amendments of the House to the bill (S. 3065) to amend the Federal Election Campaign Act of 1971 to provide for its administration by a Federal Election Commission appointed in accordance with the requirements of the Constitution, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the Senate recede from its disagreement to the amendment of the House to the text of the bill and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the House amendment insert the following:

* * * * *

[31] JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

* * * * *

[72] AMENDMENTS TO INTERNAL REVENUE CODE OF 1954

ENTITLEMENT OF ELIGIBLE CANDIDATES TO PAYMENTS

Senate bill

Section 301 of the Senate bill

[1] Public Law 94-283, page 522.

amended the public financing provisions of the Internal Revenue Code of 1954 by prohibiting a presidential candidate who accepts public funds from expending more than $50,000 from his own personal funds or the funds of his immediate family in connection with his campaign. The term "immediate family" was defined to mean a candidate's spouse, and any child, parent, grandparent, brother, half-brother, sister, or half-sister of the candidate, and the spouses of such persons. Expenditures made by an individual after January 29, 1976, and before the date of enactment of the Senate bill shall not be taken into account in applying the limitation under such Code.

House amendment

Section 301 of the House amendment amended section 9004 of the Internal Revenue Code of 1954 by adding new subsections (d) and (e). Subsection (d) provides that, in order to be eligible to receive payments under section 9006, a candidate of a major, minor, or new party for election to the office of President must certify to the Commission that the candidate will not knowingly make expenditures from his personal funds, or the personal funds of his immediate family, in connection with his campaign for election to the office of President, in excess of an aggregate amount of $50,000. Expenditures made by a vice president nominee shall be considered to be expenditures made by the presidential nominee of the same political party.

Subsection (e) defines the term "immediate family" to mean the spouse of a candidate, and any child, parent, grandparent, brother, or sister of the candidate, and the spouses of such persons.

[73] Section 306(a) amended section 9035 of the Internal Revenue Code of 1954 to provide that any candidate seeking Federal matching funds in connection with a campaign for nomination for election to the office of President may not knowingly make expenditures from his personal funds, or the personal funds of his immediate family, in connection with his campaign which exceed an aggregate amount of $50,000. Section 306(a) also amended section 9035 of the Internal Revenue Code of 1954 by adding a new subsection (b) which defines the term "immediate family" to mean the spouse of a candidate, and any child, parent, grandparent, brother, or sister of the candidate, and the spouses of such persons.

Section 306(b) made a conforming amendment to the table of sections for chapter 96 of the Internal Revenue Code of 1954.

Conference substitute

The conference substitute is the same as the House amendment, except as follows:

1. The conference substitute follows the Senate bill with respect to the definition of the term "immediate family". The conference substitute does not in any way disturb the $1,000 contribution limit applicable to all individuals, including the immediate family of a candidate.

2. The conference substitute includes the provision of the Senate bill which states that expenditures made by an individual after January 29, 1976, and before the date of the enactment of the conference substitute, shall not be taken into account in applying the limitation regarding the expenditure of personal funds.

Insufficient Amounts in Presidential Election Campaign Fund

Senate bill

Section 302 of the bill amended section 9006 of the Internal Revenue Code of 1954 by striking out subsection (b). Subsection (b) provides that any moneys remaining in the Presidential Election Campaign Fund after a presidential election shall be transferred to the general fund of the Treasury.

House amendment

Section 302(a) of the House amendment amended section 9006 of the Internal Revenue Code of 1954 by striking out subsection (b). Subsection (b) provides that any moneys remaining in the Presidential Election Campaign Fund after a presidential election shall be transferred to the general fund of the Treasury.

Conference substitute

The conference substitute is the same as House amendment and the Senate bill.

Insufficient Amounts in Presidential Election Campaign Fund

Senate bill

No provision.

House amendment

Section 302(b) of the House amendment amended section 9006(c) of the Internal Revenue Code of 1954, as so redesignated by section [74] 302(a) of the House amendment, to provide that, in any case in which the Secretary of the Treasury determines that there are not sufficient moneys in the Presidential Election Campaign Fund to make payments under section 9006(b), section 9008(b)(3), and section 9037(b) of the Internal Revenue Code of 1954, moneys shall not be made available from any other source for the purpose of making payments.

Conference substitute

The conference substitute is the same as the House amendment.

Provision of Legal or Accounting Services

Senate bill

The Senate bill provided that payment for legal or accounting services shall not be treated as an expenditure by the national committee of a political party in connection with its presidential nominating convention unless the person paying for such services is a person other than the employer of the individual rendering the services.

House amendment

Section 303 of the House amendment amended section 9008(d) of the

Internal Revenue Code of 1954 by adding a new paragraph (4). Paragraph (4) provides that any payment by a person other than the national committee of a political party of compensation to any person for legal or accounting services rendered to the national committee of a political party shall not be treated as an expenditure made by the national committee with respect to the presidential nominating convention of the political party involved.

Conference substitute

The conference substitute includes a modified version of the Senate bill which provides that legal or accounting services are considered contributions if the person paying for the services is a person other than the "regular" employer of the individual rendering the services.

Review of Regulations

Senate bill

Section 303 of the bill amended the public financing provisions of the Internal Revenue Code of 1954 relating to congressinal review of regulations promulgated under such provisions, to provide for a 15-legislative-day or 30-calendar-day period, whichever is later, during which a proposed rule or reglation can be disapproved.

House amendment

Section 304(a) of the House amendment amended section 9009(c)(2) of the Internal Revenue Code of 1954 to provide that the Congress may disapprove proposed rules and regulations of the Commission in whole or in part. The amendment also provided that, whenever a committee of the House of Representatives reports any resolution relating to a proposed rule or regulation of the Commission, it is in order at any time (even though a previous motion to the same effect has been disagreed to) to move to proceed to the consideration of the resolution. The motion is highly privileged and is not debatable. An amendment to the motion is not in order, and it is not in order to move to reconsider the vote by which the motion is agreed to or disagreed to. [75] Although the motion to proceed to the consideration of the resolution is not debatable, debate may be conducted with respect to the contents of the resolution.

Section 304(b) made an identical amendment to section 9039(c)(2) of the Internal Revenue Code of 1954.

Conference Substitute

The conference substitute is the same as the House amendment, except as follows:

The conference substitute provides that, for purposes of reviewing regulations proposed by the Commission, the Congress may disapprove any provision or series of interrelated provisions which states a single separable rule of law.

The conferees agree that this provision does not give the Congress the power to revise proposed regulations by disapproving a particular word, phrase, or sentence, but only gives each House of the Congress the power to determine which proposed regulations of the Commission constitute distinct regulations which can only be disapproved in whole. This provision is intended to permit disapproval of discrete self-contained sections or subdivisions of proposed regulations and is not intended to permit the rewriting of regulations by piecemeal changes.

Return of Federal Funds

Senate bill

Section 306 of the Senate bill amended section 9037 of the Internal Revenue Code of 1954 to provide that a candidate receiving Federal matching funds in connection with his presidential primary campaign may not continue to receive matching funds if he fails to receive 10 percent or more of the votes cast in 2 consecutive primaries. The Senate bill provided that the eligibility of a candidate to receive matching funds may be reinstated if the candidate receives 20 percent or more of the votes cast in a presidential primary held after the candidate's payments were terminated.

The Senate bill provided that this provision would take effect on the date of the enactment of the Senate bill.

House amendment

Section 307(a)(1) of the House amendment section 9002(2) of the Internal Revenue Code of 1954 to provide that the term "candidate" does not include any individual who has ceased actively to seek election to the office of President or to the office of Vice President in more than one State.

Section 307(a)(2) amended section 9003 of the Internal Revenue Code of 1954 by adding a new subsection (d). Subsection (d) provides that, in any case in which an individual ceases to be a candidate for the office of President or Vice President as a result of the operation of the last sentence of section 9002(2) of the Internal Revenue Code of 1954 (which is added by the amendment made by section 307(a)(1) of the House amendment), such individual (1) shall no longer be eligible to receive any Federal payments; and (2) shall pay to the Secretary of the Treasury, as soon as practicable after the date upon which the individual ceases to be a candidate, an amount equal to the amount of payments received by the individual which are not used to defray qualified campaign expenses.

[76] Section 307(b) made amendments to section 9032(2) of the Internal Revenue Code of 1954 and to section 9033 of such Code which are substantially similar to the amendments made by section 307(a). The amendments made by section 307(b) relate to the receipt of Federal matching payments in presidential primary elections.

Conference substitute

The conference substitute includes both the provisions of the House amendment and the Senate bill. The conference substitute provides that an individual who has ceased to be an active candidate, or an individual who is ineligible to receive payments because he has failed to receive at least 10 percent of the votes cast in 2 con-

secutive primaries, may continue to receive Federal payments only in order to defray qualified campaign expenses which were incurred while such individual was a candidate.

The conference substitute also provides that an individual who becomes ineligible to receive matching payments under section 9033(c)(1)(A) of the Internal Revenue Code of 1954, as added by the conference substitute, subsequently may reestablish his eligibility to receive such payments. The Commission is given authority to determine that any such individual is a candidate upon a finding that such individual is actively seeking election to the office of President of the United States in more than one State. The Commission is required to make such determination without requiring such individual to resubmit written agreements under section 9033(a) of the Internal Revenue Code of 1954.

The conferees agree that the provision of the conference substitute relating to the ineligibility of inactive candidates to receive matching payments is intended to provide that a candidate will remain eligible for such payments only so long as he maintains a good faith, multistate campaign for nomination for election, or for election, to the office of President. A candidate should not be considered to be actively seeking nomination or election if he curtails his campaign activities to such an extent that it is reasonable to conclude that he no longer intends to engage in activity necessary to secure the nomination or win the election involved.

TECHNICAL AND CONFORMING AMENDMENTS

The Senate bill and the House amendment made various technical and conforming amendments to the Internal Revenue Code of 1954. The conference substitute incorporates these technical and conforming amendments.

* * * * *

[77] WAYNE L. HAYS,
JOHN H. DENT,
JOHN BRADEMAS,
DAWSON MATHIS,
MENDEL J. DAVIS,
CHARLES E. WIGGINS,
Managers on the Part of the House.

HOWARD W. CANNON,
CLAIBORNE PELL,
ROBERT C. BYRD,
HUGH SCOTT,
MARK O. HATFIELD,
Managers on the Part of the Senate.

Public Law 94-331
94th Congress, H. R. 10051 [1]
June 30, 1976

An Act to amend section 815 of the Internal Revenue Code to allow a life insurance company to disregard (for purposes of that section) a distribution during the last month of its taxable year, determined to have been made out of the policyholders surplus account, if such distribution is returned to the company not later than the due date for filing its income tax return (including extensions thereof) for that year, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 815(d) of the Internal Revenue Code of 1954 (relating to special rules for distributions to shareholders) is amended by adding at the end thereof the following new paragraph:

"(6) RESTORATION OF AMOUNTS DISTRIBUTED OUT OF POLICYHOLDERS SURPLUS ACCOUNT.—Notwithstanding any other provision of this subchapter, no amount shall be subtracted from a taxpayer's policyholders surplus account with respect to a distribution made during the last month of the taxable year which, without regard to this paragraph, would be treated in whole or in part as a distribution out of the policyholders surplus account, to the extent that amounts so distributed are returned to the taxpayer no later than the time prescribed by law (including extensions thereof) for filing the taxpayer's return for the taxable year in which the distribution was made. For purposes of this paragraph, amounts returned to a taxpayer with respect to a distribution shall be first applied to the return of amounts which, without regard to this paragraph, would have been treated as distributed out of the policyholders surplus account. This paragraph shall not apply if, at the time such distribution was made, the taxpayer intended to avail itself of the provisions of this paragraph by having its shareholders return all or a part of such distribution. Nothing in this paragraph shall affect the tax treatment of the receipt of the distribution by any shareholder, and the basis to a shareholder of his stock in the taxpayer shall not be increased by reason of amounts returned under this paragraph to the extent that a dividends received deduction or exclusion was allowable in respect of the distribution of such amount under any provision of this title.".

(b) The amendment made by this section shall apply with respect to taxable years ending after December 31, 1957.

SEC. 2. EXCLUSION FROM INCOME UNDER THE SUPPLEMENTAL SECURITY INCOME PROGRAM.

(a) IN GENERAL.—Section 1612(b) of the Social Security Act is amended—

(1) by striking out the word "and" which appears at the end of paragraph (9),

(2) by striking out the period at the end of paragraph (10) and by inserting in lieu thereof "; and",

(3) by inserting the following new paragraph:

"(11) assistance received under the Disaster Relief Act of 1974 or other assistance provided pursuant to a Federal statute on account of a catastrophe which is declared to be a major disaster by the President.".

(b) EFFECTIVE DATE.—The amendments made by this Act shall be applicable only in the case of catastrophes

[1] House Report No. 94-1263, page 529.

which occur on or after June 1, 1976 and before December 31, 1976.

SEC. 3. WITHHOLDING; ESTIMATED TAX PAYMENTS.

(a) WITHHOLDING.—

(1) IN GENERAL.—Section 3402(a) of the Internal Revenue Code of 1954 (relating to income tax collected at source) is amended by striking out "July 1, 1976" and inserting in lieu thereof "September 1, 1976".

(2) TECHNICAL AMENDMENT.—Section 209(c) of the Tax Reduction Act of 1975 is amended by striking out "July 1, 1976" and inserting in lieu thereof "September 1, 1976".

(b) ESTIMATED TAX PAYMENTS BY INDIVIDUALS.—Section 6153(g) of such Code (relating to installment payments of estimated income by individuals) is amended by striking out "July 1, 1976" and inserting in lieu thereof "September 1, 1976".

(c) ESTIMATED TAX PAYMENTS BY CORPORATIONS.—Section 6154(h) of such Code (relating to installment payments of estimated income by corporations) is amended by striking out "July 1, 1976" and inserting in lieu thereof "September 1, 1976".

SEC. 4. AMENDMENT TO SUPPLEMENTAL SECURITY INCOME PROGRAM.

(a) IN GENERAL.—Section 1612 (a)(2)(A) of the Social Security Act is amended—

(1) by striking out the word "and" which appears at the end of clause (i) thereof and by inserting a comma in lieu of such word, and

(2) by inserting immediately before the semicolon at the end thereof the following: ", and (iii) support and maintenance shall not be included and the provisions of clause (i) shall not be applicable in the case of any individual (and his eligible spouse, if any) for the period which begins with the month in which such individual (or such individual and his eligible spouse) began to receive support and maintenance while living in a residential facility (including a private household) maintained by another person and ends with the close of the month in which such individual (or such individual and his eligible spouse) ceases to receive support and maintenance while living in such a residential facility (or, if earlier, with the close of the fifth month following the month in which such period began), if, not more than 30 days prior to the date on which such individual (or such individual and his eligible spouse) began to receive support and maintenance while living in such a residential facility, (I) such individual (or such individual and his eligible spouse) were residing in a household maintained by such individual (or by such individual and others) as his or their own home, (II) there occurred within the area in which such household is located (and while such individual, or such individual and his spouse, were residing in the household referred to in subclause (I) a catastrophe on account of which the President declared a major disaster to exist therein for purposes of the Disaster Relief Act of 1974, and (III) such individual declares that he (or he and his eligible spouse) ceased to continue living in the household referred to in subclause (II) because of such catastrophe".

(b) EFFECTIVE DATE.—The amendments made by this Act shall be applicable only in the case of catastrophes which occur on or after June 1, 1976 and before December 31, 1976.

Approved June 30, 1976.

House of Representatives Report No. 94-1263 2d Session

[Bracketed numerals indicate official report page numbers]

TAX TREATMENT OF CERTAIN DISTRIBUTIONS OF LIFE INSURANCE COMPANIES

June 14, 1976

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 10051[1]

[1] Public Law 94-331, page 528.

The Committee on Ways and Means, to whom was referred the bill (H.R. 10051) to amend section 815 of the Internal Revenue Code to allow a life insurance company to disregard (for purposes of that section) a distribution during the last month of its taxable year, determined to have been made out of the policyholders surplus account, if such distribution is returned to the company not later than the due date for filing its income tax return (including extensions thereof) for that year, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 1, strike out lines 3 to 5, inclusive, and insert:

That (a) section 815(d) of the Internal Revenue Code of 1954 (relating to special rules for distributions to shareholders) is amended by adding at the end thereof the following new paragraph:

Page 2, line 20, strike out "The" and insert:

Nothing in this paragraph shall affect the tax treatment of the receipt of the distribution by any shareholder, and the

Page 2, line 22, strike out "extent that" and insert in lieu thereof "extent that a".

Page 3, strike out lines 1 to 4, inclusive, and insert:

(b) The amendment made by this section shall apply with respect to taxable years ending after December 31, 1957.

[2] I. SUMMARY

The bill (H.R. 10051) prevents imposition of a special tax on life insurance companies (the so-called "phase III tax") in the case of an inadvertent distribution by the company from the policyholders surplus account, where the amount distributed is promptly returned to the company.

II. GENERAL STATEMENT

Present law

Under present law, the taxable in-

come of a stock life insurance company for a taxable year consists of three elements referred to as phase I, phase II, and phase III (sec. 802). Phase I consists of the lesser of the taxable investment income[1] of the life insurance company for that year or its gain from operations for that year; phase II consists of one-half of the excess, if any, of the company's gain from operations over its taxable investment income for that year; and phase III generally consists of the portion of the other half of such excess which is treated as distributed to shareholders of the company for the year. Thus, a stock life insurance company's taxable investment income for a particular year and one-half of its underwriting income (the excess of its gains from operations over its taxable investment income) are taxed on a current basis. The portion of its underwriting income which is not taxed currently is generally taxed as phase III income when it is treated as distributed to shareholders.

Under the Internal Revenue Code, a stock life insurance company credits the tax-deferred half of its underwriting gains to a policyholders surplus account.[2] Amounts may be subtracted from the policyholders surplus account, credit to the shareholders surplus account, and distributed to shareholders (sec. 815). Under these rules, however, amounts subtracted from the policyholders surplus account for a taxable year are includable in the life insurance company's taxable income for that year.

In order to determine the amount of phase III income for a particular taxable year, the amount actually distributed from the policyholders surplus account is "grossed-up". The gross-up is necessary to equate the insurance company with an ordinary corporation.

Reasons for change

The life insurance company tax rules provide a priority system for determining whether a distribution to shareholders is derived from the shareholders surplus account, the policyholders surplus, or other accounts. Under this system, distributions to shareholders are considered to be made from the policyholders surplus account only after the balance of the shareholders surplus account has been reduced to zero. Thus, if a life insurance company makes a distribution to shareholders in excess of the balance of its shareholders surplus account, the excess is considered to be from the policyholders surplus account (limited to the balance of that account).

[3] It has been pointed out that the phase III tax may be approximately half of the gross amount or may exceed 90 percent of the amount actually distributed from the policyholders surplus account (in the case of distributions made in the period when the 10-percent surtax was in effect (1968 and 1969), the phase III tax could exceed 110 percent of that amount) and that such a tax may be irrevocably triggered by a distribution which results from an inadvertent error in making complex computations.

The Internal Revenue Service has interpreted present law to require a life insurance company to pay the phase III tax on a wholly unintentional distribution out of the policyholders surplus account even though the shareholders of the company promptly return the distribution upon learning of the error, and even though the company has a long-standing policy of limiting its distributions to stockholders to amounts in the shareholders surplus account and footnoting its published financial statements with a statement that the company has "no present plans for distributing the amounts in policyholders surplus". Under this interpretation, amounts distributed out of the policyholders surplus account by mistake are held subject to the phase III tax even though they were restored to the company before its return for the year was due.

Explanation of the bill

Your committee's bill prevents the imposition of the phase III tax on amounts inadvertently distributed by a life insurance company from the policyholders surplus account. It provides that no amount is to be subtracted from an insurance company's policyholder surplus account with respect to a distribution made during the last month of the company's taxable year (which distribution would otherwise be treated as a distribution out of the policyholders surplus account) to the extent the amounts so distributed are returned to the company no later than the time prescribed by law (including extensions thereof) for filing the company's return for the taxable year in which the distribution was made.

Under the bill, the amounts so returned are to be applied first to restore the amounts which would otherwise be treated as distributed out of the policyholders surplus account.

The relief provided by the bill is not to be available if at the time the distribution was made by the company, it intended to avail itself of the provisions of the bill by having its shareholders return all or a part of the distribution.

The distribution is to be taxed to the shareholders under the usual rules. Under the bill, the basis to a shareholder of his stock in the company is not to be increased by reason of amounts returned under these rules to the extent that a dividends received deduction or exclusion is allowable with respect to the distribution.

The bill provides relief for the Business Men's Assurance Company of America (BMA) with respect to a distribution made in December 1969. The amount of the inadvertent BMA distribution was nearly $5.5 million. When grossed up, the amount subject to tax was about $11.5 million. In this

[1] Generally, the taxable investment income of a life insurance company is the life insurance company's share of the yield on its investments, reduced by investment expenses, depreciation, depletion, certain real estate expenses and trade or business expenses. The policyholder's share of investment yield is not taxed to the company.

[2] Section 815 provides limitations on the amount which may be credited to the policyholder's surplus account.

case, the principal shareholder of the company promptly returned the distribution upon learning of the error.

[4] *Effective date*

The bill applies with respect to taxable years ending after December 31, 1957 (the effective date of the Life Insurance Company Tax Act of 1959, which established the three-phase system of taxing life insurance companies).

III. Effect of the Bill on the Revenues and Vote of the Committee in Reporting the Bill

In compliance with clause 7 of rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect of this bill on the revenues. Your committee estimates that, other than the revenue loss involved with respect to BMA (approximately $6 million), the bill is not expected to have any significant effect on the revenues in the future. The Treasury Department agrees with this statement.

In compliance with clause 2(l)(2)(B) of rule XI of the Rules the House of Representatives, the following statement is made relative to the vote of the Committee on reporting the bill. This bill, as amended, was ordered reported by voice vote.

IV. Other Matters Required To Be Discussed Under House Rules

In compliance with clause 2(l)(3) of the rule XI of the Rules of the House of Representatives, the following statements are made:

With respect to subdivision (A), relating to oversight findings, it was a result of your committee's oversight activity concerning the application of the life insurance company tax provisions that the committee concluded that the phase III tax should not be applied under the circumstances provided in the bill.

With respect to subdivision (B), your committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

With respect to subdivisions (C) and (D), your committee advises that no estimate or comparison has been submitted to your committee by the Director of the Congressional Budget Office relative to any of the provisions of H.R. 10051 nor have any oversight findings or recommendations been submitted to your committee by the Committee on Government Operations with respect to the subject matter of H.R. 10051.

In compliance with clause 2(l)(4) of rule XI of the Rules of the House of Representatives, your committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

Public Law 94-396 94th Congress, H.R. 3052 [1] September 3, 1976

An act to amend section 512(b)(5) of the Internal Revenue Code of 1954 with respect to the tax treatment of the gain on the lapse of options to buy or sell securities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 512(b)(5) of the Internal Revenue Code of 1954 (relating to modifications to unrelated business taxable income) is amended by inserting after the first sentence the following new sentence: "There shall also be excluded all gains on the lapse or termination of options, written by the organization in connection with its investment activities, to buy or sell securities (as defined in section 1236(c))."

(b) The amendment made by subsection (a) shall apply to gain from options which lapse or terminate on or after January 1, 1976, in taxable years ending on or after such date.

Sec. 2. (a) The following provisions of the Internal Revenue Code of 1954 are amended by striking out "September 1, 1976" and inserting in lieu thereof "September 15, 1976":

(1) section 3402(a) (relating to income collected at source);

(2) section 6153(g) (relating to installment payments of estimated income tax by individuals); and

(3) section 6154(h) (relating to installment payments of estimated income tax by corporations).

(b) Section 209(c) of the Tax Reduction Act of 1975 is amended by striking out "September 1, 1976" and inserting in lieu thereof "September 15, 1976".

Approved September 3, 1976.

[1] Senate Report No. 94-1172, this page; House Report No. 94-1134 is not published.

Senate Report No. 94-1172 2d Session

[Bracketed numerals indicate official report page numbers]

TAX TREATMENT OF CERTAIN OPTION INCOME OF EXEMPT CORPORATIONS

August 26, 1976

Mr. Long, from the Committee on Finance, submitted the following report to accompany H.R. 3052.[1]

The Committee on Finance, to which was referred the bill (H.R. 3052) to amend section 512(b)(5) of the Internal Revenue Code of 1954 with respect to the tax treatment of the gain on the lapse of options to buy or sell securities, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

I. Summary

The bill (H.R. 3052) deals with the application of the unrelated business income tax to income which an exempt organization receives from writing options to buy or sell securities in cases where the option is allowed to lapse, or is terminated. Under present law, premiums received for options which are "exercised" are treated as part of the gain or loss on the sale of the property

[1] Public Law 94-396, this page.

involved—that is, usually as capital gain or loss. However, premiums for options which are allowed to lapse or are terminated generally are treated as ordinary income. In the case of most exempt organizations, capital gains—which include premiums from exercised options—are excluded from the unrelated business income tax as a part of the general exclusion for these organizations' investment income. In addition, most tax-exempt organizations are not taxed on dividend or interest income. This bill adds gains from the lapse or termination of options to buy or sell securities to the exempt category of income for exempt organizations (except for those categories of organizations taxed on investment income). This bill does not change the treatment of exercised options.

[2] II. General Statement

Present law

With the exception of social clubs and employees' beneficiary associations,[1] the investment income of exempt organizations generally is not subject to the tax on unrelated business income.[2] The types of investment income sources listed as being free of this tax include dividends, interest, annuities, royalties, and capital gains from the sale of investment assets.

The tax treatment of income which an exempt organization receives from writing options to buy or sell securities depends on whether the option is exercised, lapses, or is terminated. If a "call" option written by an exempt organization on a security in connection with its investment activities is exercised and the security is required to be sold by the exempt organization, the premium received for the option is treated as part of the gain or loss from the sale of the security. In this case the entire gain on the sale—including the premium on the option—realized by the exempt organization is free of tax because under present law (sec. 512 (b)(5) of the Internal Revenue Code of 1954) the term "unrelated business taxable income" excludes all gains or losses from the sale, exchange, or other disposition of property (except in the case of inventory and property held for sale to customers). Similarly, if a "put" option written on the security in connection with an exempt organization's investment activities is exercised and the security is required to be purchased by the exempt organization, the premium income received for the option is treated as reducing the purchase price of the security. Subsequently, if the security is sold, this reduced purchase price means a larger capital gain (or smaller capital loss) on the sale of the security, which, as noted above, is excluded from the tax base of the exempt organization.

On the other hand, if an option written by the exempt organization (in the case of either a put or a call) is not exercised and the option lapses, the premium which the exempt organization receives generally is treated as ordinary income rather than as income from the sale of property.[3] As a result, the premium received by an exempt organization [3] on a lapsed option generally is subject to the unrelated business income tax.

Until recently, put and call options were traded exclusively "over-the-counter" through put and call brokers. The over-the-counter options are contracts between the specific buyer and specific writer. This means that while the buyer can exercise his option any time he wishes, the writer cannot terminate his obligation except by repurchasing the specific option he has written.

In 1973, trading began on listed options on the Chicago Board Options Exchange (CBOE). Unlike over-the-counter options, listed options consist of two contracts—one between the buyer and the CBOE and the other between the writer and the CBOE. A writer of a listed option can terminate his obligation by buying a listed option identical to the one he has written. This is called a "closing purchase transaction." The CBOE then cancels the two identical options. Currently the CBOE, the American Stock Exchange and the Philadelphia-Baltimore-Washington Stock Exchange all list call options, and they are expected soon to begin trading put options. Gain on an offsetting "closing purchase transaction" is also treated as ordinary income under present law.

Reasons for change

An option writer cannot foresee whether the purchase (holder) will exercise the option. In addition, a writer may determine that its economic interest is best served by executing a closing

[1] In this report further references to "exempt organizations" do not include these two categories (secs. 501(c)(7) and (9)).

[2] In the case of "debt financed property", different rules apply and the investment income may be taxable in part. Those rules are dealt with under sections 514 of the Internal Revenue Code of 1954 and are not amended by this bill.

Also, private foundations are taxed on investment income under section 4940. This bill does not change the rules with regard to that tax.

[3] Present law (sec. 1234(a)) provides that gain or loss in the case of the sale or exchange of an option is to be given the same treatment as would the gain or loss on the sale of the property to which the option relates. However, under sec. 1234 (b), if the option holder fails to exercise the option, this provision indicates that only in the case of a loss is the failure to be treated as having the same character as the underlying property. Where there is a gain on the failure to exercise an option, the regulations provide (sec. 1.1234-1(b)) that this gain represents ordinary income to the writer of the option (even though the payment of the premium by the holder of the lapsed option results in a capital loss to that holder). In private letter rulings, the Service has held that an option writer's gain from the expiration or lapse, and his gain or loss from a closing transaction on an option is ordinary income or loss.

Under present law (sec. 1234(c)) gain from the lapse of an option written as part of a "straddle" (a simultaneously granted combination of an option to buy and an option to sell the same quantity of a security at the same price during the same period of time, is treated as gain from the sale or exchange of a capital asset held for not more than 6 months on the date that the option expired (see Treas. Regs. § 1X1234-2(f), example (3)). Consequently, option lapse income from "straddles" is already excluded from unrelated business taxable income of exempt organizations (other than in the case of social clubs, employees' beneficiary associations, and private foundations, and other than in the case of debt-financed property, as noted above).

purchase transaction on an option which it has written. The committee believes that it is inappropriate to tax income from options which are written by exempt organizations and which lapse or are terminated, as unrelated business income merely because such lapse or termination income is categorized as ordinary income. Taxing such income is inconsistent with the generally tax-free treatment accorded to exempt organizations' income from investment activities.

Explanation of bill

The bill amends present law (sec. 512(b)(5)) to exclude from the term "unrelated business taxable income" all gains on the lapse or termination of options to buy or sell securities,[4] when the options have been written in connection with the exempt organization's investment activities. The rule of the bill is to apply, whether or not the option is "covered". Thus, the term "unrelated business taxable income" is to exclude all premiums received by an exempt organization on options which it writes under these circumstances, regardless of whether the option is exercised, lapses, or is terminated.

This bill has the effect of overriding for the future a 1966 Internal Revenue Service ruling[5] that "income realized by the organization from unexercised 'call' options is * * * subject to the unrelated business income tax * * *. It is immaterial that income received by the organization from the sale of securities resulting from exercised options [4] is excluded from the base of the unrelated business income by section 512(b) of the Code."

It is not intended that this treatment be available if the exempt organization writing the options takes such an active role in this activity that its options can be regarded as inventory or as being held for sale to customers in the ordinary course of its trade or business, or if the underlying securities on which the options are written constitute inventory or are being held for sale, etc.; such activities go beyond the concept of production of investment income that is intended to be exempted. Also, it is not intended that this bill detract from the court's decision in *Randall Foundation* v. *Riddell*, that securities trading can be so large a part of the activities of an organization that the organization fails to meet the statutory test of being "organized and operated exclusively for religious, charitable, scientific," etc., purposes and thus does not qualify for exemption from tax.

Effective date

This amendment applies to gains from options which lapse or are terminated January 1, 1976, regardless of whether the exempt organization involved is a calendar year taxpayer or a fiscal year taxpayer.

III. Costs of Carrying Out the Bill and Vote of the Committee in Reporting H.R. 3052

Revenue cost

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out H.R. 3052. The committee estimates that this bill will have at most a small effect (under $1,000,000) on the revenues. The Treasury Department agrees with this statement.

In accordance with section 403 of the Congressional Budget Act of 1974, the Director of the Congressional Budget Office has not made an estimate or comparison of the estimates of the cost of H.R. 3052, but has examined the committee's estimates and agrees with the methods and the dollar estimates resulting therefrom.

Vote of the committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill H.R. 3052, was ordered reported by a voice vote.

Tax expenditures

With respect to the effects of the committee amendment on tax expenditures during the next five fiscal years, the following statement is made:

In accordance with section 308(a)(2) of the Congressional Budget Act of 1974, after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

[4] For this purpose, the definition of a security is that provided by section 1236(c) of the Code, as "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence or an interest in or right to subscribe to or purchase any of the foregoing."

[5] Rev. Rul. 66-47, 1966-1 C.B. 149.

Public Law 94-401
94th Congress, H.R. 12455 [1]
September 7, 1976

An Act to amend title XX of the Social Security Act so as to permit greater latitude by the States in establishing criteria respecting eligibility for social services, to facilitate and encourage the implementation by States of child day care services programs conducted pursuant to such title, to promote the employment of welfare recipients in the provision of child day care services, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

* * * * *

Sec. 4. (a) Section 50A(a) of the Internal Revenue Code of 1954 (relating to amount of credit for work incentive program expenses) is amended—

(1) by adding at the end of paragraph (2) the following new sentence: "The preceding sentence shall not apply to so much of the credit allowed by section 40 as is attributable

[1] This publication of the law is restricted to excerpts involving tax matters; Senate Report No. 94-857, page 534; Conference Report No. 94-1317 and House Report No. 94-903 are not published.

to Federal welfare recipient employment incentive expenses described in subsection (a)(6)(B).", and

(2) by striking out paragraph (6) and inserting in lieu thereof the following:

"(6) LIMITATION WITH RESPECT TO CERTAIN ELIGIBLE EMPLOYEES.—

"(A) NONBUSINESS ELIGIBLE EMPLOYEES. — Notwithstanding paragraph (1), the credit allowed by section 40 with respect to Federal welfare recipient employment incentive expenses paid or incurred by the taxpayer during the taxable year to an eligible employee whose services are not performed in connection with a trade or business of the taxpayer shall not exceed $1,000.

"(B) CHILD DAY CARE SERVICES ELIGIBLE EMPLOYEES.—Notwithstanding paragraph (1), the credit allowed by section 40 with respect to Federal welfare recipient employment incentive expenses paid or incurred by the taxpayer during the taxable year to an eligible employee whose services are performed in connection with a child day care services program, conducted by the taxpayer, shall not exceed $1,000.".

(b) Section 50B(a)(2) of such Code (relating to definitions; special rules) is amended to read as follows:

"(2) DEFINITIONS.—For purposes of this section, the term 'Federal welfare recipient employment incentive expenses' means the amount of wages paid or incurred by the taxpayer for services rendered to the taxpayer by an eligible employee—

"A) before July 1, 1976, or

"(B) in the case of an eligible employee whose services are performed in connection with a child day care services program of the taxpayer, before October 1, 1977.".

(c) The amendments made by this section with respect to Federal welfare recipient employment incentive expenses paid or incurred by the taxpayer to an eligible employee whose services are performed in connection with a child day care services program of the taxpayer shall apply to such expenses paid or incurred by a taxpayer to an eligible employee whom such taxpayer hires after the date of the enactment of this Act.

* * * * *

Approved September 7, 1976.

Senate Report No. 94-857 2d Session [1]

[Bracketed numerals indicate official report page numbers]

CHILD CARE AND SOCIAL SERVICES PROGRAMS

MAY 13, 1976

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 12455.

The Committtee on Finance, to which was referred the bill (H.R. 12455) to extend from April 1 to October 1, 1976, the maximum period during which recipients of services on September 30, 1975, under titles IV-A and VI of the Social Security Act, may continue to receive services under title XX of that Act without individual determinations, having considered the same, reports favorably thereon with an amendment and an amendment to the title and recommends that the bill as amended do pass.

* * * * *

[12] TAX CREDIT FOR EMPLOYING WELFARE RECIPIENTS IN CHILD CARE

(Section 4 of the bill)

The Committee wishes to encourage child care providers to hire welfare recipients in meeting the additional staff needs. For this reason, the Committee bill extends the tax credit for child care providers hiring welfare recipients. Under existing law, this tax credit is scheduled to expire June 30, 1976. The Committee bill extends it for child care jobs through September 30, 1977.

The tax credit would equal 20 percent of up to the first $5,000 in wages per year paid each welfare recipient employed in the provision of child care (an annual limit of $1,000 per employee). This 20 percent credit on the wages of welfare recipients could be used by centers to match Federal funds for child care under title XX of the Social Security Act.

With regard to public and nonprofit providers who have no tax liability, States could make payments up to $5,000 per year per employee.

A tax credit for hiring welfare recipients was first authorized under the 1971 Revenue Act. This credit applies only to wages paid recipients of aid to families with dependent children (AFDC) who are placed in employment through the Work Incentive (WIN) program. In order to be eligible for this credit (generally equal to 20 percent of the gross wages of the employee during the first 12 months of employment), the employee must be retained by the employer for an additional 12-month period following the first 12 months.

In the Tax Reduction Act of 1975, the Congress authorized for a temporary period a new Federal Welfare Recipient Employment Incentive Tax Credit broader in application than the WIN tax credit. The tax credit in the Committee bill for hiring welfare recipients in the provision of child care is modeled after the Federal Welfare Recipient Employment Incentive Tax Credit in that it applies solely to the employment of a welfare recipient who:

(A) has been certified by the State or local welfare department as being eligible for financial assistance for aid to families with [13] dependent children and as having continuously received such financial assistance during the 90-day period which immediately precedes the date on which such individual is hired by the taxpayer,

(B) has been employed by the taxpayer for a period in excess of 30 consecutive days on a substantially full-time basis (thus after the eligible employee had worked the first 30 days,

[1] Public Law 94-401, page 533.

the taxpayer would receive the credit for the wages paid or incurred by the taxpayer for the first 30 days of employment plus the wages for all days the employee continued to work after the original 30-day period),

(C) has not displaced any other individual from employment by the taxpayer,

(D) is not a migrant worker (for purposes of this tax credit, a migrant worker means an individual who is employed for services for which the customary period of employment by one employer is less than 30 days if the nature of such services requires the employee to travel from place to place for a short period of time), and

(E) is not a close relative of the taxpayer (bearing any of the relationships to the taxpayer described in paragraphs (1) through (8) of section 152(a) of the Internal Revenue Code of 1954 as amended).

The tax credit for child care providers in the Committee bill differs from the Federal Welfare Recipient Employment Incentive Tax Credit in that:

(1) It is applicable through September 30, 1977; and

(2) It applies in all cases only to the first $5,000 of wages (The Federal Welfare Recipient Employment Incentive Tax Credit is limited to the first $5,000 of wages only in the case of services not performed in connection with a trade or business).

* * * * *

Public Law 94-414
94th Congress, H.R. 5071 [1]
September 17, 1976

An act to amend section 584 of the Internal Revenue Code of 1954 with respect to the treatment of affiliated banks for purposes of the common trust fund provisions of such Code.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 584(a) of the Internal Revenue Code of 1954 (relating to common trust funds) is amended by adding at the end thereof the following new sentence: "For purposes of this subsection, two or more banks which are members of the same affiliated group (within the meaning of section 1504) shall be treated as one bank for the period of affiliation with respect to any fund of which any of the member banks is trustee or two or more of the member banks are co-trustees.".

SEC. 2. The amendment made by the first section of this Act shall apply to taxable years beginning after December 31, 1975.

SEC. 3. WITHHOLDING; ESTIMATED TAX PAYMENTS.

(a) WITHHOLDING.—

(1) IN GENERAL.—Section 3402 (a) of the Internal Revenue Code of 1954 (relating to income tax collected at source) is amended by striking out "September 15, 1976" and inserting in lieu thereof "October 1, 1976".

(2) TECHNICAL AMENDMENT.—Section 209(c) of the Tax Reduction Act of 1975 is amended by striking out "September 15, 1976" and inserting in lieu thereof "October 1, 1976".

(b) ESTIMATED TAX PAYMENTS BY INDIVIDUALS.—Section 6153(g) of such Code (relating to installment payments of estimated income by individuals) is amended by striking out "September 15, 1976" and inserting in lieu thereof "October 1, 1976".

(c) ESTIMATED TAX PAYMENTS BY CORPORATIONS.—Section 6154(h) of such Code (relating to installment payments of estimated income by corporations) is amended by striking out "September 15, 1976" and inserting in lieu thereof "October 1, 1976".

Approved September 17, 1976.

[1] Senate Report No. 94-1183, this page; House Report No. 94-892 is not published.

Senate Report No. 94-1183
2d Session

[Bracketed numerals indicate official report page numbers]

MAINTENANCE OF COMMON TRUST FUND BY AFFILIATED BANKS

August 27, 1976

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 5071 [1]

The Committee on Finance, to which was referred the bill (H.R. 5071) to amend section 584 of the Internal Revenue Code of 1954 with respect to the treatment of affiliated banks for purposes of the common trust fund provisions of such Code, having considered the same, reports favorably thereon without amendment, and recommends that the bill do pass.

I. SUMMARY

H.R. 5071 modifies the rules relating to the maintenance of common trust funds by banks. Under present law a bank may maintain a common trust fund (the income of which is taxed to the participants rather than it being taxed as a corporation) for the collective investment and reinvestment of moneys transferred to the bank in its fiduciary capacity. The Internal Revenue Service has taken the position that a fund which accepts contributions from other banks acting in a fiduciary capacity (even though the banks are affiliated) will not qualify as a common trust fund. This bill provides that where banks which are members of the same affiliated group establish a combined common trust fund, this fund is to be treated as a "common trust fund" for tax purposes during the period of the affiliation.

II. GENERAL STATEMENT

Under existing law a bank may maintain a "common trust fund" which fund itself is neither subject to

[1] Public Law 94-414, this page.

Federal income taxation nor considered a corporation. A fund qualifies as a common trust fund if it is (1) maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed by the bank in its fiduciary [2] capacity, and (2) maintained in conformity with rules and regulations of the Comptroller of the Currency pertaining to the collective investment of trusts. The income (including gains and losses from the sale of property) from the fund, representing amounts contributed from various separate trusts, is included in the gross income of each participant in the common fund on the basis of its proportionate share of the income.

The purpose of the common trust fund provision is to permit diversification in the investment of trust funds for which a bank has fiduciary responsibility.

The Internal Revenue Service has taken the position (Rev. Rul. 70-302) [1970-1 C.B. 140] that a fund maintained by a member bank of a bank holding company will not qualify as a "common trust fund" if it accepts contributions to the fund by other member banks (or trust companies) acting in a fiduciary capacity. The Internal Revenue Service holds that under present law the common trust fund must be "maintained" by the bank which contributes the moneys to the fund for investment. The committee also understands that the Internal Revenue Service holds that a fund maintained by various members of a bank holding company will not qualify even if each member bank acts as a cotrustee of the common fund.

The committee believes that the tax treatment accorded a common fund by banks which are related through stockholdership with a common parent should be the same as where only one bank is involved because the State where it is located permits branch banking. The committee sees no substantive reason for a difference in tax treatment in these cases and no reason why the pooling of the trust funds for investment purposes should not be permitted. It is the committee's understanding that the Comptroller of the Currency supports this bill and will encounter no additional difficulty in regulating and administering common trust funds maintained by affiliated banks.

Accordingly, the bill amends the provision dealing with common trust funds (sec. 584) to provide that when banks become members of the same affiliated group (within the meaning of sec. 1504) they are, for purposes of this provision, to be treated as one bank for the period of their affiliation. Consequently, if banks are affiliated (as defined in sec. 1504) they may contribute funds held in their capacity as trustee, executor, administrator or guardian to a common trust fund.

It is not necessary under the bill that banks contributing money to the fund act as cotrustees of the common trust fund. The affiliated group of banks may maintain a common trust fund if any member of the group serves as trustee. (Of course, one or more members of the affiliated group may serve as cotrustees, but this is not required.) If a common trust fund in which several affiliated banks participate is later divided because of termination of the affiliation, in those cases where there is not the effect of a sale or exchange or withdrawal, it is intended that the tax consequences of the division be governed by rules similar to those applied under existing rulings relating to the division of common trust funds maintained by a single bank.[1]

The bill applies to taxable years beginning after December 31, 1975.

[3] III. Cost of Carrying Out the Bill and Committee Vote

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the effect on the revenues of this bill. The enactment of H.R. 5071 will have no effect, or at most a negligible effect, on revenues. The Treasury Department agrees with this statement.

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote of the Committee on reporting this bill. This bill was ordered favorably reported by the Committee by voice vote.

[1] See Rev. Rul. 68-77, 1968-1 C.B. 289; Rev. Rul. 70-322, 1970-1 C.B. 141.

Public Law 94-452
94th Congress, H.R. 11997[1]
October 2, 1976

An Act to amend the Internal Revenue Code of 1954 with respect to the tax treatment of certain divestitures of assets by bank holding companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. Short Title.

This Act may be cited as the "Bank Holding Company Tax Act of 1976".

Sec. 2. Distributions Pursuant To Bank Holding Company Act Amendments of 1970.

(a) Tax-Free Distributions.—Part VIII of subchapter O of chapter 1 of the Internal Revenue Code of 1954 (relating to distributions pursuant to Bank Holding Company Act of 1956 [Pub. L. 511, 1956-1 C.B. 875]) is amended to read as follows:

"PART VIII—DISTRIBUTIONS PURSUANT TO BANK HOLDING COMPANY ACT

"Sec. 1101. Distributions pursuant to Bank Holding Company Act.
"Sec. 1102. Special rules.
"Sec. 1103. Definitions.

"Sec. 1101. Distributions Pursuant To Bank Holding Company Act.

"(a) Distributions of Certain Non-Banking Property.—

"(1) Distributions of prohibited property.—If—

"(A) a qualified bank holding cor-

[1] Senate Report No. 94-1192, page 543; House Report No. 94-879 is not published.

poration distributes prohibited property (other than stock received in an exchange to which subsection (c)(2) applies)—

"(i) to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation, or

"(ii) to a shareholder, in exchange for its preferred stock, or

"(iii) to a security holder, in exchange for its securities, and

"(B) the Board has, before the distribution, certified that the distribution of such prohibited property is necessary or appropriate to effectuate section 4 of the Bank Holding Company Act,

then no gain to the shareholder or security holder from the receipt of such property shall be recognized.

"(2) DISTRIBUTIONS OF STOCK AND SECURITIES RECEIVED IN AN EXCHANGE TO WHICH SUBSECTION (c)(2) APPLIES.—If—

"(A) a qualified bank holding corporation distributes—

"(i) common stock received in an exchange to which subsection (c)(2) applies to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation, or

"(ii) common stock received in an exchange to which subsection (c)(2) applies to a shareholder, in exchange for its common stock, or

"(iii) preferred stock or common stock received in an exchange to which subsection (c)(2) applies to a shareholder, in exchange for its preferred stock, or

"(iv) securities or preferred or common stock received in an exchange to which subsection (c)(2) applies to a security holder in exchange for its securities, and

"(B) any preferred stock received has substantially the same terms as the preferred stock exchanged, and any securities received have substantially the same terms as the securities exchanged,

then, except as provided in subsection (f), no gain to the shareholder or security holder from the receipt of such stock or such securities or such stock and securities shall be recognized.

"(3) PRO RATA AND OTHER REQUIREMENTS.—

"(A) IN GENERAL.—Paragraphs (1) and (2) of this subsection, or paragraphs (1) and (2) of subsection (b), as the case may be, shall apply to any distribution to the shareholders of a qualified bank holding corporation only if each distribution—

"(i) which is made by such corporation to its shareholders after July 7, 1970, and on or before the date on which the Board makes its final certification under subsection (e), and

"(ii) to which such paragraph (1) or (2) applies (determined without regard to this paragraph),

meets the requirements of subparagraph (B), (C), or (D).

"(B) PRO RATA REQUIREMENTS.—A distribution meets the requirements of this subparagraph if the distribution is pro rata with respect to all shareholders of the distributing qualified bank holding corporation or with respect to all shareholders of common stock of such corporation.

"(C) REDEMPTIONS WHEN UNIFORM OFFER IS MADE.—A distribution meets the requirements of this subparagraph if the distribution is in exchange for stock of the distributing qualified bank holding corporation and such distribution is pursuant to a good faith offer made on a uniform basis to all shareholders of the distributing qualified bank holding corporation or to all shareholders of common stock of such corporation.

"(D) NON-PRO RATA DISTRIBUTIONS FROM CERTAIN CLOSELY-HELD CORPORATIONS.—A distribution meets the requirements of this subparagraph if such distribution is made by a qualified bank holding corporation which does not have more than 10 shareholders (within the meaning of section 1371(a)(1)) and does not have as a shareholder a person (other than an estate) which is not an individual, and if the Board (after consultation with the Secretary or his delegate) certifies that—

"(i) a distribution which meets the requirements of subparagraph (B) or (C) is not appropriate to effectuate section 4 or the policies of the Bank Holding Company Act, and

"(ii) the distribution being made is necessary or appropriate to effectuate section 4 of the policies of such Act.

"(4) EXCEPTION.—This subsection shall not apply to any distribution by a corporation if such corporation, a corporation having control of such corporation, or a subsidiary of such corporation has made any distribution pursuant to subsection (b) or has made an election under section 6158 with respect to bank property (as defined in section 6158(f)(3)).

"(5) DISTRIBUTIONS INVOLVING GIFT OR COMPENSATION.—In the case of a distribution to which paragraph (1) or (2) applies but which—

"(A) results in a gift, see section 2501 and following, or

"(B) has the effect of the payment of compensation, see section 61.

"(b) CORPORATION CEASING TO BE A BANK HOLDING COMPANY.—

"(1) DISTRIBUTIONS OF PROPERTY WHICH CAUSE A CORPORATION TO BE A BANK HOLDING COMPANY.—If—

"(A) a qualified bank holding corporation distributes property (other than stock received in an exchange to which subsection (c)(3) applies)—

"(i) to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation, or

"(ii) to a shareholder, in exchange for its preferred stock, or

"(iii) to a security holder, in exchange for its securities, and

"(B) the Board has, before the distribution, certified that—

"(i) such property is all or part of the property by reason of which such corporation controls (within the meaning of section 2(a) of the Bank Holding Company Act) a bank or bank holding company, or such property is part of the property by reason of which such corporation did control

a bank or a bank holding company before any property of the same kind was distributed under this subsection or exchanged under subsection (c)(3), and

"(ii) the distribution is necessary or appropriate to effectuate the policies of such Act,

then no gain to the shareholder or security holder from the receipt of such property shall be recognized.

"(2) DISTRIBUTIONS OF STOCK AND SECURITIES RECEIVED IN AN EXCHANGE TO WHICH SUBSECTION (c)(3) APPLIES.—if—

"(A) a qualified bank holding corporation distributes—

"(i) common stock received in an exchange to which subsection (c)(3) applies to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation, or

"(ii) common stock received in an exchange to which subsection (c)(3) applies to a shareholder in exchange for its common stock, or

"(iii) preferred stock or common stock received in an exchange to which subsection (c)(3) applies to a shareholder, in exchange for its preferred stock, or

"(iv) securities or preferred or common stock received in an exchange to which subsection (c)(3) applies to a security holder, in exchange for its securities, and

"(B) any preferred stock received has substantially the same terms as the preferred stock exchanged, and any securities received have substantially the same terms as the securities exchanged,

then, except as provided in subsection (f), no gain to the shareholder or security holder from the receipt of such stock or such securities or such stock and securities shall be recognized.

"(3) PRO RATA AND OTHER REQUIREMENTS.—For pro rata and other requirements, see subsection (a)(3).

"(4) EXCEPTION.—This subsection shall not apply to any distribution by a corporation if such corporation, a corporation having control of such corporation, or a subsidiary of such corporation has made any distribution pursuant to subsection (a) or has made an election under section 6158 with respect to prohibited property.

"(5) DISTRIBUTION INVOLVING GIFT OR COMPENSATION.—In the case of a distribution to which paragraph (1) or (2) applies but which—

"(A) results in a gift, see section 2501 and following, or

"(B) has the effect of the payment of compensation, see section 61.

"(c) PROPERTY ACQUIRED AFTER JULY 7, 1970.—

"(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), subsection (a) or (b) shall not apply to —

"(A) any property acquired by the distributing corporation after July 7, 1970, unless (i) gain to such corporation with respect to the receipt of such property was not recognized by reason of subsection (a) or (b), or (ii) such property was received by it in exchange for all of its stock in an exchange to which paragraph (2) or (3) applies, or (iii) such property was acquired by the distributing corporation in a transaction in which gain was not recognized under section 305(a) or section 332, or under section 354 or 356 (but only with respect to property permitted by section 354 or 356 to be received without the recognition of gain or loss) with respect to a reorganization described in section 368(a)(1)(A), (B), (E), or (F), or

"(B) any property which was acquired by the distributing corporation in a distribution with respect to stock acquired by such corporation after July 7, 1970, unless such stock was acquired by such corporation (i) in a distribution (with respect to stock held by it on July 7, 1970, or with respect to stock in respect of which all previous applications of this clause are satisfied) with respect to which gain to it was not recognized by reason of subsection (a) or (b), or (ii) in exchange for all of its stock in an exchange to which paragraph (2) or (3) applies, or (iii) in a transaction in which gain was not recognized under section 305(a) or section 332, or under section 354 or 356 (but only with respect to property permitted by section 354 or 356 to be received without the recognition of gain or loss) with respect to a reorganization described in section 368(a)(1)(A), (B), (E), or (F), or

"(C) any property acquired by the distributing corporation in a transaction in which gain was not recognized under section 332, unless such property was acquired from a corporation which, if it had been a qualified bank holding corporation, could have distributed such property under subsection (a)(1) or (b)(1), or

"(D) any property acquired by the distributing corporation in a transaction in which gain was not recognized under section 354 or 356 with respect to a reorganization described in section 368(a)(1)(A) or (B), unless such property was acquired by the distributing corporation in exchange for property which the distributing corporation could have distributed under subsection (a)(1) or (b)(1).

"(2) EXCHANGES INVOLVING PROHIBITED PROPERTY.—If—

"(A) any qualified bank holding corporation exchanges (i) property, which, under subsection (a)(1), such corporation could distribute directly to its shareholders or security holders without the recognition of gain to such shareholders or security holders, and other property (except property described in subsection (b)(1)(B)(i)), for (ii) all of the stock of a second corporation created and availed of solely for the purpose of receiving such property,

"(B) immediately after the exchange, the qualified bank holding corporation distributes all of such stock in a manner prescribed in subsection (a)(2)(A), and

"(C) before such distribution, the Board has certified (with respect to the property exchanged which consists of property which, under subsection (a)(1), such corporation could distribute directly to its shareholders

or security holders without the recognition of gain) that the exchange and distribution are necessary or appropriate to effectuate section 4 of the Bank Holding Company Act,

then paragraph (1) shall not apply with respect to such distribution.

"(3) EXCHANGES INVOLVING INTERESTS IN BANKS.—If—

"(A) any qualified bank holding corporation exchanges (i) property which, under subsection (b)(1), such corporation could distribute directly to its shareholders or security holders without the recognition of gain to such shareholders or security holders, and other property (except prohibited property), for (ii) all of the stock of a second corporation created and availed of solely for the purpose of receiving such property.

"(B) immediately after the exchange, the qualified bank holding corporation distributes all of such stock in a manner prescribed in subsection (b)(2)(A), and

"(C) before such distribution, the Board has certified (with respect to the property exchanged which consists of property which, under subsection (b)(1), such corporation could distribute directly to its shareholders or security holders without the recognition of gain) that—

"(i) such property is all or part of the property by reason of which such corporation controls (within the meaning of section 2(a) of the Bank Holding Company Act) a bank or bank holding company, or such property is part of the property by reason of which such corporation did control a bank or a bank holding company before any property of the same kind was distributed under subsection (b)(1) or exchanged under this paragraph, and

"(ii) the exchange and distribution are necessary or appropriate to effectuate the policies of such Act,

then paragraph (1) shall not apply with respect to such distribution.

"(d) DISTRIBUTIONS TO AVOID FEDERAL INCOME TAX.—

"(1) PROHIBITED PROPERTY.—Subsection (a) shall not apply to a distribution if, in connection with such distribution, the distributing corporation retains, or transfers after July 7, 1970, to any corporation, property (other than prohibited property) as part of a plan one of the principal purposes of which is the distribution of the earnings and profits of any corporation.

"(2) BANKING PROPERTY.—Subsection (b) shall not apply to a distribution if, in connection with such distribution, the distributing corporation retains, or transfers after July 7, 1970 to any corporation, property (other than property described in subsection (b)(1)(B)(i)) as part of a plan one of the principal purposes of which is the distribution of the earnings and profits of any corporation.

"(e) FINAL CERTIFICATION.—

"(1) FOR SUBSECTION (a).—Subsection (a) shall not apply with respect to any distribution by a corporation unless the Board certifies, before the close of the calendar year following the calendar year in which the last distribution occurred, that the corporation has (before the expiration of the period prohibited property is permitted under the Bank Holding Company Act to be held by a bank holding company) disposed of all of the property the disposition of which is necessary or appropriate to effectuate section 4 of the Bank Holding Company Act.

"(2) FOR SUBSECTION (b).—Subsection (b) shall not apply with respect to any distribution by a corporation unless the Board certifies, before the close of the calendar year following the calendar year in which the last distribution occurred, that the corporation has (before the expiration of the period prohibited property is permitted under the Bank Holding Company Act to be held by a bank holding company) ceased to be a bank holding company.

"(f) CERTAIN EXCHANGES OF SECURITIES.—In the case of an exchange described in subsection (a)(2)(A)(iv) or subsection (b)(2)(A)(iv), subsection (a) or subsection (b) (as the case may be) shall apply only to the extent that the principal amount of the securities received does not exceed the principal amount of the securities exchanged.

"SEC. 1102. SPECIAL RULES.

"(a) BASIS OF PROPERTY ACQUIRED IN DISTRIBUTIONS.—If, by reason of section 1101, gain is not recognized with respect to the receipt of any property, then, under regulations prescribed by the Secretary or his delegate—

"(1) if the property is received by a shareholder with respect to stock without the surrender by such shareholder of stock, the basis of the property received and of the stock with respect to which it is distributed shall, in the distributee's hands, be determined by allocating between such property and such stock the adjusted basis of such stock, or

"(2) if the property is received by a shareholder in exchange for stock or by a security holder in exchange for securities, the basis of the property received shall, in the distributee's hands, be the same as the adjusted basis of the stock or securities exchanged, increased by the amount of gain to the taxpayer recognized on the property received.

"(b) PERIODS OF LIMITATION.—The periods of limitation provided in section 6501 (relating to limitations on assessment and collection) shall not expire, with respect to any deficiency (including interest and additions to the tax) resulting solely from the receipt of property by shareholders in a distribution which is certified by the Board under subsection (a), (b), or (c) of section 1101, until 5 years after the distributing corporation notifies the Secretary or his delegate (in such manner and with such accompanying information as the Secretary or his delegate may by regulations prescribe)—

"(1) that the final certification required by subsection (e) of section 1101 has been made, or

"(2) that such final certification will not be made;

and such assessment may be made notwithstanding any provision of law or rule of law which would otherwise prevent such assessment.

"(c) ALLOCATION OF EARNINGS AND PROFITS.—

"(1) DISTRIBUTION OF STOCK IN A CONTROLLED CORPORATION.—In the case of a distribution by a qualified bank holding corporation under section 1101 (a)(1) or (b)(1) of stock in a controlled corporation, proper allocation with respect to the earning and profits of the distributing corporation and the controlled corporation shall be made under regulations prescribed by the Secretary or his delegate.

"(2) EXCHANGES DESCRIBED IN SECTION 1101(c)(2) OR (3).—In the case of any exchange described in section 1101(c)(2) or (3), proper allocation with respect to the earnings and profits of the corporation transferring the property and the corporation receiving such property shall be made under regulations prescribed by the Secretary or his delegate.

"(3) DEFINITION OF CONTROLLED CORPORATION.—For purposes of paragraph (1), the term 'controlled corporation' means a corporation with respect to which at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock is owned by the distributing qualified bank holding corporation.

"(d) ITEMIZATION OF PROPERTY.—In any certification under this part, the Board shall make such specification and itemization of property as may be necessary to carry out the provisions of this part.

"SEC. 1103. DEFINITIONS.

"(a) BANK HOLDING COMPANY; BANK HOLDING COMPANY ACT.—For purposes of this part—

"(1) BANK HOLDING COMPANY.—The term 'bank holding company' means—

"(A) a bank holding company within the meaning of section 2(a) of the Bank Holding Company Act, or

"(B) a bank holding company subsidiary within the meaning of section 2(d) of such Act.

"(2) BANK HOLDING COMPANY ACT.—The term 'Bank Holding Company Act' means the Bank Holding Company Act of 1956 [Pub. L. 511, 1956-1 C.B. 875] as amended through December 31, 1970 (12 U.S.C. 1841 et seq.).

"(b) QUALIFIED BANK HOLDING CORPORATION.—

"(1) IN GENERAL.—Except as provided in paragraph (2), for purposes of this part the term 'qualified bank holding corporation' means any corporation (as defined in section 7701 (a)(3)) which is a bank holding company and which holds prohibited property acquired by it—

"(A) on or before July 7, 1970,

"(B) in a distribution in which gain to such corporation with respect to the receipt of such property was not recognized by reason of subsection (a) or (b) of section 1101, or

"(C) in exchange for all of its stock in an exchange described in section 1101 (c)(2) or (c)(3).

"2) LIMITATIONS.—

"(A) A bank holding company shall not be a qualified bank holding corporation, unless it would have been a bank holding company on July 7, 1970, if the Bank Holding Company Act Amendments of 1970 had been in effect on such date, or unless it is a bank holding company determined solely by reference to—

"(i) property acquired by it on or before July 7, 1970,

"(ii) property acquired by it in a distribution in which gain to such corporation with respect to the receipt of such property was not recognized by reason of subsection (a) or (b) of section 1101, or

"(iii) property acquired by it in exchange for all of its stock in an exchange described in section 1101(c)(2) or (3).

For purposes of this subparagraph, property held by a corporation having control of the corporation or by a subsidiary of the corporation shall be treated as held by the corporation.

"(B) A bank holding company shall not be a qualified bank holding corporation by reason of property described in subparagraph (B) of paragraph (1(or clause (ii) of subparagraph (A) of this paragraph, unless such property was acquired in a distribution with respect to stock, which stock was acquired by such bank holding company—

"(i) on or before July 7, 1970,

"(ii) in a distribution (with respect to stock held by it on July 7, 1970, or with respect to stock in respect of which all previous applications of this clause are satisfied) with respect to which gain to it was not recognized by reason of subsection (a) or (b) of section 1101, or

"(iii) in exchange for all of its stock in an exchange described in section 1101(c)(2) or (3).

"(C) A corporation shall be treated as a qualified bank holding corporation only if the Board certifies that it satisfies the foregoing requirements of this subsection.

"(3) CERTAIN SUCCESSOR CORPORATIONS.—For purposes of this subsection, a successor corporation in a reorganization described in section 368 (a)(1)(F) shall succeed to the status of its predecessor corporation as a qualified bank holding corporation.

"(c) PROHIBITED PROPERTY.—For purposes of this part, the term 'prohibited property' means, in the case of any bank holding company, property (other than nonexempt property) the disposition of which would be necessary or appropriate to effectuate section 4 of the Bank Holding Company Act if such company continued to be a bank holding company beyond the period (including any extensions thereof) specified in subsection (a) of such section. The term 'prohibited property' also includes shares of any company not in excess of 5 percent of the outstanding voting shares of such company if the prohibitions of section 4 of such Act apply to the shares of such company in excess of such 5 percent.

"(d) NONEXEMPT PROPERTY.—For purposes of this part, the term 'nonexempt property' means—

"(1) obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace,

"(2) securities issued by or guaranteed as to principal or interest by a government or subdivision thereof or by any instrumentality of a government or subdivision, or

"(3) money, and the right to receive money not evidenced by a security or obligation (other than a security or obligation described in paragraph (1) or (2)).

"(e) BOARD.—For purposes of this part, the term 'Board' means the Board of Governors of the Federal Reserve System.

"(f) CONTROL; SUBSIDIARY.—For purposes of this part—

"(1) CONTROL.—Except as provided in section 1102(c)(3), a corporation shall be treated as having control of another corporation if such corporation has control (within the meaning of section 2(a)(2) of the Bank Holding Company Act) of such other corporation.

"(2) SUBSIDIARY.—The term 'subsidiary' has the meaning given to such term by section 2(d) of the Bank Holding Company Act.

"(g) ELECTION TO FOREGO GRANDFATHER PROVISION FOR ALL PROPERTY REPRESENTING PRE-JUNE 30, 1968, ACTIVITIES.—Any bank holding company may elect, for purposes of this part and section 6158, to have the determination of whether property is property described in subsection (c) or is property eligible to be distributed without recognition of gain under section 1101(b)(1) made under the Bank Holding Company Act as if such Act did not contain the proviso of section 4(a)(2) thereof. Any election under this subsection shall apply to all property described in such proviso and shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. Any such election, once made, shall be irrevocable. An election under this subsection or subsection (h) shall not apply unless the final certification referred to in section 1101(e) or section 6158(c)(2), as the case may be, includes a certification by the Board that the bank holding company has disposed of either all banking property or all nonbanking property.

"(h) ELECTION TO DIVEST ALL BANKING OR NONBANKING PROPERTY IN CASE OF CERTAIN CLOSELY HELD BANK HOLDING COMPANIES.—Any bank holding company may elect, for purposes of this part and section 6158, to have the determination of whether property is property described in subsection (c) or is property eligible to be distributed without recognition of gain under section 1101(b)(1) made under the Bank Holding Company Act as if such Act did not contain clause (ii) of section 4(c) of such Act. Any election under this subsection shall apply to all property described in subsection (c), or to all property eligible to be distributed without recognition of gain under section 1101(b)(1), as the case may be, and shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. Any such election, once made, shall be irrevocable."

(b) AMENDMENT OF SECTION 311(d).—Paragraph (2) of section 311(d) of such Code (relating to exceptions and limitations to the recognition of gain where appreciated property is used to redeem stock) is amended by striking out "and" at the end of subparagraph (F), by striking out the period at the end of subparagraph (G) and inserting in lieu thereof "; and", and by adding at the end thereof the following new subparagraph:

"(H) a distribution of stock to a distributee which is not an organization exempt from tax under section 501(a), if with respect to such distributee, subsection (a)(1) or (b)(1) of section 1101 (relating to distributions pursuant to Bank Holding Company Act) applies to such distribution."

(c) CLERICAL AMENDMENT.—The table of parts for subchapter O of chapter 1 of such Code is amended by striking out "of 1956."

(d) EFFECTIVE DATE.—

(1) FOR SUBSECTION (a).—The amendments made by subsections (a) and (c) shall take effect on October 1, 1977, with respect to distributions after July 7, 1970, in taxable years ending after July 7, 1970, but only in the case of qualified bank holding corporations (within the meaning of section 1103(b) of the Internal Revenue Code of 1954, as amended by subsection (a) of this section).

(2) SPECIAL RULE FOR CERTIFYING DISTRIBUTIONS WHICH HAVE ALREADY TAKEN PLACE.—For purposes of sections 1101(a)(1)(B), 1101(a)(3)(D), 1101(b)(1)(B), 1101(c)(C), 1101(c)(3)(C), and 1101(e) of the Internal Revenue Code of 1954 (as amended by subsection (a) of this section), in the case of any distribution which takes place on or before the 90th day after the date of the enactment of this Act, a certification by the Federal Reserve Board described in any such section shall be treated as made before the distribution (or, in the case of section 1101(e), before the close of the calendar year following the calendar year in which the last distribution occurred) if application for such certification is made before the close of the 90th day after the date of the enactment of this Act.

(3) PERIOD OF LIMITATIONS.—If refund or credit of any overpayment of income tax attributable to the amendment made by subsection (a) is prevented at any time before October 1, 1978, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefore is filed before October 1, 1978.

(4) FOR SUBSECTION (b).—The amendment made by subsection (b) shall take effect on October 1, 1977, with respect to distributions after December 31, 1975, in taxable years ending after December 31, 1975.

SEC. 3. INSTALLMENT PAYMENT OF TAX.

(a) INSTALLMENT PAYMENT.—Subchapter A of chapter 62 of the Internal Revenue Code of 1954 (relating to place and due date for payment of tax) is amended by adding at the end thereof the following new section:

"SEC. 6158. INSTALLMENT PAYMENT OF TAX ATTRIBUTABLE TO DIVESTITUTES PURSUANT TO BANK HOLDING COMPANY ACT AMENDMENTS OF 1970.

"(a) ELECTION OF EXTENSION.—If, after July 7, 1970, a qualified bank holding corporation sells bank property or prohibited property, the divestiture of either of which the Board certifies, before such sale, is necessary or appropriate to effectuate section 4 or the policies of the Bank Holding Company Act, the tax under chapter 1 attributable to such sale shall, at the election of the taxpayer, be payable in equal annual installments beginning with the due date (determined without extension) for the taxpayer's return of tax under chapter 1 for the taxable year in which the sale occurred and ending with the corresponding date in 1985. If the number of installments determined under the preceding sentence is less than 10, such number shall be increased to 10 equal annual installments which begin as provided in the preceding sentence and which end on the corresponding date 10 years later. An election under this subsection shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe.

"(b) LIMITATIONS.—

"(1) TREATMENT NOT AVAILABLE TO TAXPAYER FOR BOTH BANK PROPERTY AND PROHIBITED PROPERTY.—This section shall not apply to any sale of prohibited property if the taxpayer (or a corporation having control of the taxpayer or a subsidiary of the taxpayer) has made an election under subsection (a) with respect to bank property or has made any distribution pursuant to section 1101(b). This section shall not apply to bank property if the taxpayer (or a corporation having control of the taxpayer or a subsidiary of the taxpayer) has made an election under subsection (a) with respect to prohibited property or has made any distribution pursuant to section 1101(a).

"(2) TREATMENT NOT AVAILABLE FOR CERTAIN INSTALLMENT SALES.—No election may be made under subsection (a) with respect to a sale if the income from such sale is being returned at the time and in the manner provided in section 453 (relating to installment method).

"(c) ACCELERATION OF PAYMENTS.—If an election is made under subsection (a) and before the tax attributable to such sale is paid in full—

"(1) any installment under this section is not paid on or before the date fixed by this section for its payment, or

"(2) the Board fails to make a certification similar to the applicable certification provided in section 1101(e) within the time prescribed therein (for this purpose treating the last such sale as constituting the last distribution),

then the extension of time for payment of tax provided in this section shall cease to apply, and any portion of the tax payable in installments shall be paid on notice and demand from the Secretary or his delegate.

"(d) PRORATION OF DEFICIENCY TO INSTALLMENTS.—If an election is made under subsection (a) and a deficiency attributable to the sale has been assessed, the deficiency shall be prorated to such installments. The part of the deficiency so prorated to any installment the date for payment of which has not arrived shall be collected at the same time as, and as part of, such installment. The part of the deficiency so prorated to any installment the date for payment of which has arrived shall be paid on notice and demand from the Secretary or his delegate. This subsection shall not apply if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

"(e) BOND MAY BE REQUIRED.—If an election is made under this section, section 6165 shall apply as though the Secretary were extending the time for payment of the tax.

"(f) DEFINITIONS.—For purposes of this section—

"(1) TERMS HAVE MEANING GIVEN TO THEM BY SECTION 1103.—The terms 'qualified bank holding corporation,' 'Bank Holding Company Act', 'Board'; 'control', and 'subsidiary' have the respectitve meanings given to such terms by section 1103.

"(2) PROHIBITED PROPERTY.—The term 'prohibited property' means property held by a qualified bank holding corporation which could be distributed without recognition of gain under section 1101(a)(1).

"(3) BANK PROPERTY.—The term 'bank property' means property held by a qualified bank holding corporation which could be distributed without recognition of gain under section 1101(b)(1).

"(g) CROSS REFERENCES.—

"(1) Security.—For authority of the Secretary or his delegate to require security in the case of an extension under this section, see section 6165.

"(2) Period of limitation.—For extension of the period of limitation in the case of an extension under this section, see section 6503(i)."

(b) EXTENSION OF TIME FOR COLLECTION OF TAX.—Section 6503 of such Code (relating to suspension of running of period of limitation) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

"(i) EXTENSION OF TIME FOR COLLECTING TAX ATTRIBUTABLE TO DIVESTITURES PURSUANT TO BANK HOLDING COMPANY ACT AMENDMENTS OF 1970.—The running of the period of limitations for collection of the tax attributable to a sale with respect to which the taxpayer makes an election under section 6158(a) shall be suspended for the period during which there are any unpaid installments of such tax."

(c) TECHNICAL AMENDMENTS.—

(1) The table of sections for sub-

chapter A of chapter 62 of such Code is amended by adding at the end thereof the following new item:

"Sec. 6158. Installment payment of tax attributable to divestitures pursuant to Bank Holding Company Act Amendments of 1970,"

(2) Subsection (a) of section 6151 of such Code (relating to time and place for paying tax shown on returns) is amended by striking out "section," and inserting in lieu thereof "subchapter,".

(3) Paragraph (2) of section 6601 (b) of such Code (relating to interest) is amended—

(A) by striking out "or 6156(a)" and inserting in lieu thereof ", 6156(a), or 6158(a)",

(B) by striking out "or 6156(b)" and inserting in lieu thereof ", 6156(b), or 6158(a)"; and

(C) by inserting at the end thereof the following new sentence:

"For purposes of subparagraph (A), section 6158(a) shall be treated as providing that the date prescribed for payment of each installment shall not be later than the date prescribed for payment of the 1985 installment."

(d) APPLICABILITY TO CERTAIN SUCCESSOR CORPORATIONS.—If, after July 7, 1970, and before August 1, 1974—

(1) a corporation acquires substantially all of the properties of a qualified bank holding corporation (as defined in section 1103(b) of the Internal Revenue Code of 1954) in a transaction described in sections 368 (a)(1)(A) and 368(a)(2)(D), and

(2) the acquiring corporation (or a corporation in control of the acquiring corporation acquires beneficial interests in shares described in section 2(g)(2) of the Bank Holding Company Act (as defined in section 1103 (a)(2) of the Internal Revenue Code of 1954) in a transaction to which section 351 applies,

then, the acquiring corporation (or a corporation which is in control (within the meaning of section 2(a)(2) of such Act) of the acquiring corporation or a subsidiary (within the meaning of section 2(d) of such Act) of the corporation so in control) shall be treated as a qualified bank holding corporation for purposes of section 1103(b) and 6158 of the Internal Revenue Code of 1954 and the shares described in such section 2(g)(2) shall be considered property which is acquired by such corporation, for purposes of section 1101(c)(1)(A)(iii) of the Internal Revenue Code of 1954, after July 7, 1970.

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall take effect on October 1, 1977, with respect to sales after July 7, 1970, in taxable years ending after July 7, 1970, but only in the case of qualified bank holding corporations (within the meaning of section 1103(b) of the Internal Revenue Code of 1954, as amended by section 2(a) of this Act).

(2) SPECIAL RULE FOR CERTIFYING SALES WHICH HAVE ALREADY TAKEN PLACE.—For purposes of section 6158 (a) of the Internal Revenue Code of 1954 (as added by subsection (a) of this section) in the case of any sale which takes place on or before the 90th day after the date of the enactment of this Act, a certification by the Federal Reserve Board described in section 6158(a) shall be treated as made before the sale if application for such certification is made before the close of the 90th day after the date of the enactment of this Act.

(3) REFUND OF TAX.—

(A) IN GENERAL.—If any tax attributable to a sale which occurred before October 1, 1977, is payable in annual installments by reason of an election under section 6158(a) of the Internal Revenue Code of 1954, any portion of such tax for which the due date of the installment does not occur before October 1, 1977, shall, on application of the taxpayer, be treated as an overpayment of tax.

(B) INTEREST ON OVERPAYMENTS.—For purposes of section 6611(b), in the case of any overpayment attributable to subparagraph (A), the date of the overpayment shall be the day which is 6 months after the latest of the following:

(i) the date on which application for refund or credit of such overpayment is filed,

(ii) the due date prescribed by law (determined without extensions) for filing the return of tax under chapter 1 of the Internal Revenue Code of 1954 for the taxable year the tax of which is being refunded or credited, or

(iii) the date of the enactment of this Act.

(C) EXTENSION OF PERIOD OF LIMITATIONS.—If any refund or credit of tax attributable to the application of subparagraph (A) is prevented at any time before October 1, 1978, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefore is filed before October 1, 1978.

Approved October 2, 1976.

Senate Report No. 94-1192 2d Session

[Bracketed numerals indicate official report page numbers]

BANK HOLDING COMPANY TAX ACT OF 1976

August 31, 1976

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 11997.[1]

The Committee on Finance, to which was referred the Act (H.R. 11997) to amend the Internal Revenue Code of 1954 with respect to the tax treatment of certain divestitures of assets by bank holding companies, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

I. SUMMARY

In general, the Bank Holding Company Act Amendments of 1970 require a bank holding company (generally

[1] Public Law 94-452, page 536.

any company controlling a bank) to divest either its banking or nonbanking properties on or before December 31, 1980. At the time of enactment, it was anticipated that the Congress would later consider the need for legislation to provide relief from any tax burden resulting from the divestitures required under the Amendments.

With respect to distributions previously required under the Bank Holding Company Act of 1956 [Pub. L. 511, 1956-1 C.B. 875] (and its amendment in 1966), bank holding companies which controlled two or more banks were permitted to make tax-free distributions (referred to as "spinoffs") of either their bank or nonbank assets, as the case may have been. This special treatment provided for the nonrecognition of any gain to the shareholders, upon the distribution to them of banking or nonbanking property, including stock of a subsidiary. The tax on any gain realized by shareholders, or on any property received by them, would be imposed upon their later disposition of the stock or other property received in the spinoff.

The bill provides two possible methods in which tax relief may be obtained by individuals and corporations for divestitures made by a [2] bank holding company of either bank or nonbank property under the Bank Holding Company Act Amendments of 1970. First, the bill provides that a bank holding company may distribute either bank or nonbank assets to its own shareholders without inclusion in income or recognition of gain by such shareholders. This "spinoff" approach is generally the same as that adopted for divestitures under the bank holding company legislation enacted in 1956 and 1966. Second, the bill permits a bank holding company to sell its banking or nonbanking assets in a taxable sale or exchange, and to pay the income tax incurred by it in installments over a 10-year period to the extent the tax is attributable to divestitures made pursuant to the Bank Holding Company Act Amendments of 1970.

II. Reasons for Bill

Bank holding company legislation

The Bank Holding Act of 1956 was enacted in response to a concern about concentrations of economic power if holding companies were allowed to control not only large numbers of banks but also nonbanking enterprises. A bank holding company was defined in the 1956 Act as an entity which owned or controlled 25 percent or more of the voting shares of two or more banks.

In general, a corporation coming within the terms of the bank holding company legislation was given its choice of two alternative routes—to remain a bank holding company, or to dispose of its interest in banks. If the corporation decided to remain a bank holding company subject to the supervision of the Federal Reserve Board, it had to divest itself of any so-called "prohibited property," or nonbank assets.

In 1966, a number of technical amendments were made to the 1956 Act and one exception to the definition of bank holding company was removed.[1]

During the late 1960's, there was a dramatic growth not only in the number of commercial banking enterprises which became affiliated with one-bank holding companies, but also in the extent such entities controlled commercial banking activity. As a result of this change in the structure of U.S. commercial banking ownership, the Congress enacted the Bank Holding Amendments of 1970.

Of the 1970 amendments, the most significant is the extension of the Act to cover, for the first time, one-bank holding companies (i.e., any company controlling 25 percent or more of the voting shares of a bank). As a result, one-bank holding companies are made subject to the requirements of the Federal Reserve Board regarding expansion in their banking activities. In addition, one-bank holding companies which are engaged in both banking and nonbanking activities are generally required to divest themselves of either their banking or nonbanking assets before January 1, 1981. However, a "grandfather clause" in the 1970 amendments, provided that a one-bank holding company is generally not required to divest itself of those nonbanking activities in which it was lawfully engaged on June 30, 1968.[2]

In addition, the Federal Reserve Board is authorized to determine that a company owning between 5 percent and 25 percent of the voting stock of a bank or nonbanking corporation possesses a "controlling influence" in the bank or nonbank and should also be treated as controlling the bank or nonbanking corporation.

Tax treatment of divestitures

In case of distributions required under the Bank Holding Company Act of 1956 (and its amendments in 1966), bank holding companies which controlled two or more banks were permitted to make tax-free distributions (referred to as "spinoffs") of either their bank or nonbank assets, as the case may have been. This special treatment provided for the nonrecognition of any gain to the shareholders upon the distribution to them of banking or nonbanking property, including stock of a subsidiary. Instead, tax on any gain was imposed on the shareholders upon their later disposition of the stock received in the spinoff.

In the absence of special tax legislation, many distributions required to be made pursuant to the Bank Holding

[1] The repealed exception had provided that a company was not to be considered a bank holding company if it was registered prior to May 15, 1955, under the Investment Company Act of 1940 (or was an affiliate of such a company) unless the company or its affiliate *directly* owned 25 percent or more of the voting shares of each of two or more banks.

[2] Properties which are covered by the grandfather provision are not generally subject to the divestiture requirements; however, in a situation of this type the Board retains significant controls on the authority of the bank holding company to acquire new businesses or to expand existing businesses, and may terminate applicability of the grandfather clause for a company in certain cases.

Company Act Amendments of 1970 will be taxable to the distributees as dividends subject to ordinary income rates.[3]

In addition, the bank holding company itself generally would be required to recognize gain on appreciated property (such as stock of a banking or nonbanking subsidiary) distributed by it in a redemption of its own stock, unless the distribution qualifies as a distribution in complete or partial liquidation of the company.[4]

On the other hand, if property is sold by a bank holding company to satisfy the divestiture requirements, gain is recognized. The involuntary conversion provision of the tax law (sec. 1033), which provides for nonrecognition of gain, is not available, since this provision does not treat these divestitures as an involuntary conversion. Consequently, a direct sale by a bank holding company will ordinarily be a taxable disposition, producing taxable gain or deductible loss.

While a distribution in the form of a spinoff (for which the relief provided in 1956 and 1966 may be useful for some of the divestitures made pursuant to the 1970 amendments, the number and types of bank holding companies which are subject to the 1970 legislation will, in [4] many instances, make the spinoff distribution impractical. For example, some of the bank holding companies which will be subject to the 1970 amendments are widely held. In such a situation, the distribution of the stock of a subsidiary to the shareholders of the bank holding company would frequently result in many of the holding company's shareholders receiving only a small number of shares (or in some cases fractions of whole shares). Further, if the distribution consists of stock issued by a bank which serves only a local or regional market, the shareholders of the holding company would receive an investment in which they may have little or no interest.[5]

In those cases where it is not feasible to distribute stock, many bank holding companies will be forced to sell the interests required to be divested. In these circumstances, the committee believes that an alternative form of relief should be provided.[6]

Accordingly, the bill provides two methods in which tax relief may be obtained by individuals and corporations for divestitures made by a bank holding company (pursuant to the Bank Holding Company Act Amendments of 1970) of either bank or nonbank property; namely, a "spinoff" method and an installment payment of tax method.

III. Explanation of Bill

As indicated above, the bill provides two possible methods in which tax relief may be obtained by individuals and corporations for divestitures made by a bank holding company of either bank or nonbank property pursuant to the Bank Holding Company Act Amendments of 1970.

First, the bill provides that a bank holding company may distribute either the bank or nonbank assets to its own shareholders (or, in some cases, security holders) without inclusion in income or recognition of gain by these stock (or security) holders. However, any loss realized by a shareholder (or security holder) as a result of a distribution may be recognized. This "spinoff" approach is generally the same as that adopted with respect to divestitures under the bank holding company legislation enacted in 1956 and 1966.

Second, the bill permits a bank holding company to sell its banking or nonbanking assets in a taxable sale or exchange and to pay the income incurred at the corporate level in installments over at least a 10-year period with respect to sales or exchanges made under the divestiture requirements of the Bank Holding Company Amendments of 1970.

The methods of tax relief for divestitures permitted by the bill are not intended, however, to be exclusive. As a result they do not limit the availability of any tax relief for dispositions covered specifically by other provisions of the code. For example, a bank holding company could make a required divestiture by means of a spinoff covered at the shareholder level by section 355 of present law (distribution of [5] stock of a controlled corporation) if the specific requirements of that provision are otherwise fully satisfied.

Spinoff method

With respect to the spinoff approach, the bill generally adopts the provisions contained in present law

[3] Generally, in the case of a redemption of stock by a bank holding company, the redemption would be treated as a sale or exchange of a capital asset by the shareholder, rather than a dividend, only if the redemption is not essentially equivalent to a dividend (sec. 302) or if the redemption is treated as a distribution in complete or partial liquidation of the company (sec. 331). Nonrecognition treatment would be available if the distribution qualifies under the divisive reorganization provisions of present law (sec. 355). This provision permits a corporation to distribute to its own shareholders stock of a controlled (80 percent or greater ownership) corporation without an immediate dividend tax or recognition of gain by the receiving shareholders. Under this provision, the shareholders may or may not simultaneously exchange some of their stock in the distributing company. Several prerequisites must be satisfied before this benefit under section 355 can be obtained, however. Two of these requirements are that both corporations must be engaged in active conduct of a trade or business for at least 5 years before the distribution.

[4] Under the Tax Reform Act of 1969, recognition of gain by a corporation using appreciated property to redeem its own stock was required in certain cases (sec. 311(d). Included among the exceptions to this rule was a distribution of stock or securities pursuant to a final judgment under an antitrust proceeding. A similar exception for distributions required under the Bank Holding Company Act was not considered necessary at that time.

[5] In some cases, distribution of the stock of a subsidiary to the shareholder of the holding company will not be feasible because it would result in the holding company being unable to service acquisition indebtedness, or to pay dividends on preferred stock which it issued for the original acquisition of the subsidiary.

[6] In addition to the tax relief extended under present law to divestitures required under the Bank Holding Company Act, nonrecognition of gain or loss treatment has been provided with respect to certain exchanges required under Federal Communications Commission policies (sec. 1071) and certain exchanges or distributions made in obedience to orders of the Securities and Exchange Commission (sec. 1081).

(secs. 1101-1103), which applied to divestitures made pursuant to the 1956 and 1966 bank holding company legislation.

In general, a corporation coming within the terms of the bank holding company legislation of 1970 is given its choice of two alternative routes—to remain a bank holding company and divest its prohibited nonbanking assets, or to dispose of its interest in banks and, as a result, cease to be a bank holding company.

If a corporation decides to remain a bank holding company, subject to supervision by the Federal Reserve Board, it must divest itself of any "prohibited property" (that is, nonbank property). Under the "spinoff" approach, nonbanking property (including stock) may be distributed to a bank holding company's shareholders without recognition of gain by them on the distribution.

For this purpose, "prohibited property," in general, means stock, securities or other obligations, or other assets of nonbanking businesses to the extent the bank holding company is required to divest itself of such assets, pursuant to the Bank Holding Company Act Amendments of 1970. The term does not include cash, government bonds or certain short term obligations.

The distribution of "prohibited property" may be made either directly to the shareholders of the corporation which is a bank holding company (with or without a surrender by the shareholders of some of their stock in the holding company) or may be transferred, together with other nonbank property, to a wholly owned subsidiary created expressly for the purposes of receiving the prohibited property.[7] In the latter situation, the stock of the subsidiary must be immediately distributed to the shareholders of the corporation which is a bank holding company if the distribution is to qualify for nonrecognition of gain to (or noninclusion in income of) the shareholders.

If a corporation which qualifies as a bank holding company decides to cease to be a bank holding company (that is, if it wants to continue its nonbank activities), it must divest itself of its bank property. Under the "spinoff" approach, it may distribute to its shareholders any bank stock or other property of a kind which causes it to be a bank holding company, without the recognition of gain to the distributee shareholders (if they exchange some of their stock in the holding company) or without current inclusion in their income (if they retain their stock in the holding company). As in the case where a bank holding company divests its nonbanking property, as indicated above, nonrecognition is available whether the bank stock or other similar property is distributed directly to shareholders or whether it is first transferred to a wholly owned subsidiary expressly [6] created for the purpose and the stock of the subsidiary is then immediately distributed to the shareholders of the parent company.

The spinoff provisions will not apply to a distribution of prohibited property if the bank holding company has made distributions of bank property or has made an election under the installment payment provision with respect to the sale of bank property. Conversely, the spinoff provisions will not apply with respect to distributions of bank property if distributions of prohibited property have been made by the bank holding company under the spinoff provisions, or if it has made an election to pay the tax installments with respect to prohibited property.

Pro rata distribution requirements.—In general, distributions must be pro rata either with respect to all shareholders of the distributing bank holding company or with respect to all holders of common stock of the company. In the case of distributions to several classes of shareholders, the determination of whether the distributions are pro rata is to be made on the basis of the respective fair market values of classes of stock. For this purpose, the respective fair market value of the classes of stock may be determined as of a time reasonably close to the date upon which distribution is made (e.g., two months before the distribution is actually made) so the exchange ratio, if any, may be specified in any prospectus required in connection with the distribution.

Where the distribution is in exchange for stock (i.e., a redemption of the bank holding company's own stock), the pro rata requirement will be satisfied if a good faith offer to distribute is made on a uniform basis to all shareholders (including preferred shareholders) or to all common shareholders of the holding company. The requirement of a uniform offer means that the distributing company cannot offer different types of property to different shareholders; rather, it must offer the same types of property to all of its shareholders or to all of its common shareholders.

A limited exception is provided in the bill to permit non pro rata distributions where the Federal Reserve Board requires it in order to effectively separate banking and nonbanking businesses, e.g., if the result of a pro rata distribution would be that the same small group of shareholders would continue their respective interests in two corporations rather than one. This exception applies only in the case of a qualified bank holding corporation which does not have more than 10 individual shareholders (other than an estate) at any time during the period beginning on July 7, 1970, and ending after the final distribution required under the Bank Holding Company Act is made. Further, this exception is to apply only if the Board certifies that a pro rata distribution is not appropriate to effectuate the policies

[7] In the case where a wholly owned subsidiary is created to receive the prohibited property, certain amounts of working capital may be transferred in addition to the prohibited property. However, the nonrecognition provisions of this bill would not apply if the subsidiary receives a greater amount of working capital than is necessary under the circumstances or if other evidence indicates the existence of a plan one of the principal purposes of which is to distribute earnings and profits of a corporation.

of the Bank Holding Company Act and that a disproportionate distribution is necessary or appropriate to effectuate such policies. In this case, the Board is to make such certification only after consultation with the Secretary of the Treasury or his delegate. The requirement for consultation with the Secretary or his delegate is intended to give the Treasury Department an opportunity to advise the Board with respect to tax avoidance possibilities which might result from a disproportionate distribution.

[7] Where distributions of divestiture property (banking or nonbanking property as the case may be) are made directly by a qualified bank holding corporation, the distributions may be pro rata with respect to common shareholders without the surrender of shares of the distributing company held by them. In the case where the divestiture property is transferred to a wholly owned subsidiary and then the stock of the subsidiary is distributed, the common stock of the subsidiary may be distributed to all shareholders or only to the common shareholders of the distributing corporation without the surrender of shares in the distributing corporation. In addition, preferred stock or common stock in the subsidiary may be distributed in redemption of the holding company's own common and preferred stock (subject, however, to the tender offer requirement under the pro rata rule in the bill). In addition, if the exception to the pro rata requirements applies, the holding company may distribute preferred or common stock or securities of the subsidiary in exchange for the holding company's own securities.

Effect on shareholders.—If shareholders of a bank holding company do not recognize gain on a distribution of property to them in exchange for stock or securities held by them in the holding company, the basis of the property received by a shareholder is the same as the basis of the stock or securities exchanged. If property is received by such shareholders without an exchange of stock by them, the shareholder is required to allocate his basis in the stock of the bank holding company between such stock and the property distributed to him. Thus, the tax which would have otherwise been incurred by a shareholder with respect to a distribution is generally postponed until the shareholder disposes of the stock or property which is received.

Use of appreciated property by corporation to redeem its stock.—As a result of the Tax Reform Act of 1969 [Pub. L. 91-172, 1969-3 C.B. 10], present law taxes any gain to a corporation which distributes appreciated property in redemption of its own stock (sec. 311(d)). However, a number of exceptions were provided to this rule at that time.[8] The bill adds another additional exception providing that gain will not be recognized by a corporation distributing appreciated stock of a preexisting banking or nonbanking subsidiary in redemption of its own stock.

This additional exception to section 311(d) is not to be available for distributions of assets other than stock. Moreover, the exception is to be available only for distributions made directly by the holding company (under new secs. 1101(a)(1) or (b)(1)) and does not apply to distributions of stock of any newly created subsidiary.[9] This exception is not to apply where the distributee is a tax-exempt organization.

[8] The rule does not apply to (1) a distribution in partial or complete liquidation of a corporation, (2) a distribution of stock or securities in a divisive reorganization, (3) certain complete redemptions of a 10-percent shareholder, (4) certain distributions of stock of a 50-percent controlled corporation, (5) certain distributions of stock or securities pursuant to the terms of a judgment requiring divestiture under the antitrust laws, (6) certain distributions in redemption of stock to pay death taxes, (7) certain distributions to a private foundation in redemption of stock, and (8) certain distributions by a regulated investment company in redemption of its stock.

[9] If stock of a newly created subsidiary could be distributed under the protection of the new exemption to sec. 311(d), the rule limiting the exception to stock distributions could be circumvented by transferring business assets to a newly created subsidiary and then distributing the stock of that subsidiary to the shareholders of the bank holding company.

Other than this exception for the distribution of appreciated stock, the usual provisions of the tax laws applying to the distributing company. [8] That is, gain generally is recognized to the distributing corporation in the case of distributions of LIFO inventory, in the case of distributions of property subject to a liability in excess of its adjusted basis, and in the case of distributions of certain installment obligations (secs. 311 and 453). In the case of distributions of property in kind, the depreciation recapture provisions are to apply as under present law (secs. 1245 and 1250). Further, the investment credit recapture provisions are to apply as under present law with respect to dispositions of depreciable tangible property (sec. 47).

Installment method

The second form of tax relief provided by the bill permits the taxpayer to make installment payments of the tax attributable to a divestiture accomplished by a sale or taxable exchange of bank or nonbank property, as the case may be. Under the installment payment provision, a bank holding company selling bank property or nonbank property, after July 7, 1970, may elect to pay the tax attributable to the sale in equal annual installments. The first installment is to be due on the due date of the taxpayer's return of taxes for the taxable year in which the sale occurred. The installments are to be paid annually thereafter with the last installment payable on the due date of the taxpayer's return in 1985, or, if later, on the corresponding date 10 years after the due date for the year in which the sale occurred. If the taxpayer makes more than one sale under the 1970 bank holding company legislation, the tax attributable to each sale may be paid on an installment basis beginning in the year after each sale was made.

As indicated above, the bill provides for a minimum installment period of 10 years. Thus, in the case of a sale in 1980, the installment period would be available until 1990 (rather than 1985). However, interest is not im-

posed upon the deferred tax in the case of installments due through 1985, but is payable with respect to installment payments due after 1985.

The installment payment of tax is not to be available for a sale of nonbank property if the bank holding company elects to apply the provision to the sale of bank property or if the company has distributed bank property under the spinoff provisions. Conversely, the installment payment of tax is not to apply with respect to a sale of bank property if the bank holding company elects to pay the tax in installments with respect to nonbank property or has distributed nonbank property under the spinoff provisions. If the bank holding company elects to report gain on a sale under the regular installment method (section 453), it is not to be entitled also to elect for this sale the special installment method provided here.

If the company elects to pay the tax in installments, the payments are to be accelerated and the tax paid in full if (i) an installment is not paid on or before its due date; or (ii) the Federal Reserve Board fails to make a certification, within the time prescribed that the company has disposed of all the property the disposition of which is necessary to effectuate the policies of the Bank Holding Company Act or that the company has ceased to be a bank holding company.

If the company elects to pay the tax in installments, the Secretary of the Treasury or his delegate may, if he feels that it is necessary to ensure payment of the tax, require the company to furnish a bond. The provision relating to bonds (sec. 6165) where the time to pay the [9] tax has been extended, is to apply as though the Secretary is extending the time for the payment of tax. The running of the period of limitations for the collection of the tax attributable to a sale is to be suspended for the period during which there are any unpaid installments.

Rules of General Applicability

The tax relief provided under the bill is available for divestitures occurring from July 7, 1970, through December 31, 1980. In general, a bank holding company must be qualified as such and the property being divested must have been held as of July 7, 1970. This date is the date upon which the Senate Banking and Currency Committee announced that it was reporting out a bill dealing with one-bank holding companies. This restriction is considered necessary to preclude tax relief for acquisitions made after it became clear that the separation of banking and nonbanking businesses was to be required of the one-bank holding companies.

Since the Bank Holding Company Act of 1970 requires all divestitures to be made by December 31, 1980, the tax relief is made available only for those divestitures which will have taken place by that date.

Qualification of holding company.—Under the bill, a bank holding company is treated as a "qualified bank holding corporation" only if it was "controlling" a bank for purposes of the Bank Holding Company Act as of July 7, 1970, or is later determined to be a qualified bank holding company because of (1) property acquired by it on or before July 7, 1970, or (2) property received after such date in a distribution from another qualified bank holding corporation, or (3) stock of a subsidiary it acquired after that date if the subsidiary was created for the purpose of receiving property required to be distributed by the company.

Generally, this definition includes a company which directly or indirectly owned 25 per cent or more of the stock of a bank or another bank holding company on July 7, 1970. In addition, the definition includes a company subsequently determined to be a bank holding company by the Federal Reserve Board because it exercises a "controlling influence" over a bank if the determination was made on the basis of the bank shares owned as of July 7, 1970, by the company. Thus, in such a case, the determination of the Federal Reserve Board is to be given retroactive effect for purposes of the tax provisions. Of course, the provisions of the bill relate solely to the treatment of a company as a qualified bank holding corporation for tax purposes. They do not relate in any respect to the effect, if any, of the Board's determination for purposes of the Bank Holding Company Act, e.g., applicability of grandfather privileges under the Act.[10]

The bill extends the tax relief provisions to distributions or sales by a subsidiary of a bank holding company. These distributions or sales would be subject to the same requirements applicable to the "parent" holding company, e.g., the property must satisfy the cutoff date and [10] the Federal Reserve Board must certify that divestiture is necessary or appropriate to effectuate the policies of the Act.[11] For this purpose, the term "subsidiary" has

[10] Generally, it is the position of the Federal Reserve Board that a determination relating to the status of a company as a bank holding company will be retroactive only when the company directly owned as much as 25 percent of a bank. A finding that a company is a bank holding company because of its "controlling influence" is not given retroactive effect. (Federal Reserve Order of January 15, 1976, relating to *Orwig & Co., Inc.*, and *Perpetual Corp.-Pierce National Life Insurance Co.*, 1973 Federal Reserve Bulletin 218.) In most cases, the prospective determination of status as a bank holding company results in the denial of grandfather privileges under the Bank Holding Company Act.

[11] In certain cases, a parent corporation may be treated as a bank holding company because its subsidiary owns stock in a bank. If the corporation owning the bank stock is a subsidiary for purposes of tax law (generally the parent corporation owns 80 percent of the voting stock), tax relief under the divestiture provisions is available because the subsidiary could be liquidated into the parent corporation without the recognition of gain, and then the parent corporation could distribute the bank stock to its shareholders without recognition of income by the shareholders. However, a company may be treated as a subsidiary of a bank holding company under the bank holding company provisions if the holding company owns 25 percent or more of its stock. Thus, in the case where a corporation is treated as a subsidiary under the Bank Holding Company Act but not under the Internal Revenue Code, bank stock owned by the subsidiary may not be distributed without the recognition of income unless it is treated as a bank holding company.

the same meaning as under the Bank Holding Company Act, i.e., generally, a subsidiary is a company in which the holding company directly or indirectly owns 25 percent or more of the voting stock.

Under the bill, a successor corporation in a type "F" reorganization (mere change in identity or place of incorporation) is to be treated as a qualified bank holding corporation if its predecessor satisfied the qualification requirements.

Eligibility of property.—The tax relief is, generally, available only for distributions of property owned on July 7, 1970, by a qualified bank holding corporation. This restriction is not generally to apply to property acquired after that date if it is received in a distribution by another bank holding corporation, or to the stock of a subsidiary which is created to receive the property required to be distributed by the holding company.

In addition, the cutoff date is not generally to apply to certain other "substituted" property received by a bank holding company in a nontaxable transaction. Thus, the cutoff date is not to apply to nontaxable stock dividends received by the holding company, property received in a liquidation of a subsidiary in which gain or loss was not recognized, and property received in certain reorganizations to the extent gain or loss was not recognized. The reorganizations within the scope of the substituted property rules include mergers (a type "A" reorganization),[12] stock-for-stock exchanges (a type "B" reorganization), recapitalizations (a type "E" reorganization) and mere changes in identity or place of incorporation (a type "F" reorganization). If, in any of these reorganizations, additional consideration is received by the holding company which is required to be recognized under present law (sec. 356), this additional property is not to be treated as substituted property under the bill (although the additional consideration will not prevent nonrecognition property received in the same reorganization from being treated as substituted property for purposes of this bill).

The substituted property rules are to apply to property received in the liquidation of a subsidiary only if the property could have been distributed to shareholders without the recognition of income under the provisions, e.g., the property was held by the subsidiary on July 7, 1970. Property received in a merger or stock-for-stock exchange are to qualify under the substituted property rules if it is received in exchange for property which satisfied the cutoff date and the substituted property is also required to be divested. Also, there may be successive transactions involving substituted property and the substituted property [11] rules will be satisfied so long as the property acquired after July 7, 1970, can be traced back through successive tax-free transactions to property held on that date.

Under present law, one of the requirements for a tax-free reorganization is that there be a continuity of interest on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization (Reg. § 1.368-1). The Internal Revenue Service has ruled that the continuity of interest requirements are satisfied even though, at the time of the reorganization, a shareholder was required by a court decree under the antitrust laws to dispose of the stock by the end of a 7-year period (Rev. Rul. 66-23, 1966-1 C.B. 67). The committee understands that in some situations a bank holding company which desires to continue to engage solely in nonbanking activities may, before making a divestiture, transfer its banking properties to another corporation in a nontaxable reorganization. If stock received in the other corporation is promptly divested by the holding company, the prior transaction might not qualify as a tax-free reorganization on continuity of interest grounds because of the divestiture requirements. Solely in order to facilitate divestitures under the tax provisions of the bill, the committee intends that the tax status of a reorganization in these circumstances should not be adversely affected by the divestiture requirements under the Bank Holding Company Act where a bank holding company disposes of shares received in the reorganization shortly after the reorganization occurs.

Five-percent ownership rule.—Regulations promulgated under present law (sec. 1101), provides that, to the extent that the distribution made by the bank holding company represents a 5 percent (or less) interest in the stock of a company, nonrecognition treatment is not available. This position is based upon the fact that the bank holding company legislation exempts from the divestiture requirement an interest in a company which does not include more than five percent of the outstanding shares of the company. Your committee believes that a bank holding company making a distribution of either bank property or nonbanking property, under the divestiture requirements of bank holding company legislation, should be eligible for tax relief under the bill on the entire amount. Consequently, the bill provides that the term "prohibited property" also includes shares of any company which a bank holding company may retain under the Bank Holding Company Act (sec. 4(c)(6)) if shares of a company are owned in excess of 5 percent and treated as property subject to the divestiture requirements of the Act.

"Grandfather" property.—The bill provides that the determination of whether property is eligible for tax relief under the bill is to be made without regard to the grandfather proviso of sec. 4(a)(2), of the Bank Holding Company Act, i.e., property held before June 30, 1968. Thus, even though property may be retained because it represents pre-June 30, 1968 activities which are not generally subject to the divestiture requirements), it may be eligible for tax relief if the Board certifies that, without regard to the grand-

[12] This would include mergers treated as a type "A" reorganization when using stock of a controlling corporation or a controlling merged corporation as described in section 368(a)(2)(D) or (E).

father privileges, the distribution is necessary or appropriate to effectuate the purposes of the bank holding company legislation. However, the tax relief is to be available only if the company irrevocably elects to forego the exemption from the divestiture requirements as to all property to which the exemption applies.

[12] *Certain family owned companies.*—The Bank Holding Company Act of 1956 (sec. 4(c)(ii)) [Pub. L. 511, 1956-1 C.B. 875] provides an exception to the divestiture requirements for a company covered by the 1970 amendments if more than 85 percent of the voting stock was collectively owned on June 30, 1968, and continuously thereafter, by members of the same family (or their spouses) who are lineal descendants of common ancestors. The bill extends the tax relief provisions to cover a company coming within this exemption if the company elects to waive the application of the exemption and dispose of either all of its bank property or all of its nonbanking property. In other respects, the requirements for obtaining the tax relief are to be the same as for any other bank holding company, e.g., the property must be held by the bank holding company on July 7, 1970 and the Federal Reserve Board must certify that the disposition is an appropriate reflection of the general divestiture requirements of the Bank Holding Company Act.

Certification by Federal Reserve Board.—Under the bill, the Federal Reserve Board is required to make both an initial certification before any distribution or sale by a bank holding company and a final certification that the required distribution or sale has been made. Initially, the Board must certify that the distribution or sale is necessary or appropriate to effectuate the policies of the bank holding company legislation. In addition, the Board must issue a final certification, before the close of the calendar year following the calendar year in which the last distribution or sale occurred, to the effect that the corporation has disposed of all the property which is necessary or Act. In the case of divestitures of bank property, nonrecognition treatment is not to apply unless the Board certifies, before the close of the calendar year following the calendar year in which the last distribution occurred, that the corporation has ceased to be a bank holding company.

The periods of limitation (provided in sec. 6501) are not to expire with respect to a deficiency resulting from a distribution made under the spinoff provisions until five years after the corporation notifies the Secretary that the final certification (referred to above) has been made or that the final certification will not be made.

Special successor corporation rules.—The bill contains a special successor corporation rule to deal with a situation brought to the committee's attention. In this case, a company became a bank holding company in 1974 through certain tax-free transactions in which it succeeded [13] to the controlling interests in banks and nonbanking assets owned by another corporation, which is a trusted affiliate. In connection with these tax-free transactions, a predecessor corporation, which would have been treated as a qualified bank holding corporation because it satisfied the general cutoff date of July 7, 1970, was merged into a newly chartered bank corporation.

The effect of this special rule is to treat the corporations involved in the tax-free transactions occurring after July 7, 1970 and before August 1, 1974 and any subsidiaries [14] of these corporations as satisfying the general cutoff date of July 7, 1970. In addition, the shares of the trusteed corporation (which are held for the benefit of the new controlling corporation as a result of the tax-free transactions) are to be [13] treated as property acquired in substitution for property which satisfied the cutoff date. The special rule would not apply to property acquired after the date on which the tax-free transactions occurred unless the general substituted property rules described above apply.

Effective Dates

The "spinoff" amendments made by the bill are to be effective with respect to distributions after July 7, 1970. The bill, however, is to take effect on October 1, 1977. The effective date of the bill is postponed until October 1, 1977, so that there will be no revenue loss until fiscal year 1978.[15]

In the case of distributions occurring before enactment of the bill, the period of limitations for refunds or credits is extended for one year following the October 1, 1977.

The provision relating to nonrecognition of gain by a corporation using appreciated property to redeem its stock is to apply to distributions made after December 31, 1975. However, the bill also provides that this provision is not to take effect until October 1, 1977.

The installment payment of tax provision is to apply to sales made after July 7, 1970. The bill, however, is not effective until October 1, 1977. As in the case of the spinoff approach, the postponement of the effective date of the bill is provided so that there will be no revenue loss until fiscal year 1978.

In the case of any sale which takes place on or before 90 days after the date of enactment, a certification by

[13] By a triangular merger and transfers of beneficial interests by the shareholders of the predecessor corporation.

[14] For this purpose, the term "subsidiary" means a subsidiary within the meaning of the Bank Holding Company Act, i.e., a company in which the holding company directly or indirectly owns 25 percent or more of the voting stock.

[15] In the case of any distribution which takes place on or before 90 days after the date of the enactment of this bill, the requirement that the Federal Reserve Board certify that the distribution is necessary or appropriate to effectuate the purposes of the Bank Holding Company Act is to be treated as made before the distribution if an application for certification is made before the close of the 90th day after the date of enactment. The final certification (required by section 1101(e)) is to be treated as made before the close of the calendar year following the calendar year in which the last distribution occurred if application for that certification is also made before the close of the 90th day after the date of enactment.

the Federal Reserve Board is to be treated as made before the sale if application for the certification is made within 90 days after the date of enactment.

In the case of a sale occurring before enactment of the bill, refunds or credits are to be available for the portion of the tax attributable to the sale not yet due on October 1, 1977 under the installment payment provision. Under the bill, no refund may be made or credit allowed under the provision before October 1, 1977.

Any refund due under this provision may be used by the Internal Revenue Service as an offset to any outstanding deficiencies as provided under present law (sec. 6402). In the case of refunds attributable to sales, in two or more taxable years the refunds attributable to the sales are to be used in the order of time as offsets to the deficiencies arising in the order of time and in the manner provided under present law where the taxpayer does not specify the liability being satisfied (first as to interest, second as to penalties, and third as to tax liabilities).

In the case of an overpayment arising from the installment provisions interest to the taxpayer is to be allowed for only for periods 6 months or more after the later of the date of enactment, the date on which application for refund is filed, or the due date for filing the income tax return for the taxable year in which the sale occurs.

[14] IV. Costs of Carrying Out the Bill and Vote of the Committee in Reporting H.R. 11997

Revenue cost

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out H.R. 11997. The bill would become effective on October 1, 1977, so that there would be no revenue effect for fiscal year 1977. Thereafter, the revenue loss is estimated to be approximately $50 million in fiscal year 1978, $25 million in fiscal year 1979, $50 million in fiscal year 1980, and $60 million in fiscal year 1981. Of this amount, $125 million would be returned to the Treasury during the period 1981 through 1990 as installment payments are made with respect to the taxes deferred under the installment payment method.

In accordance with section 403 of the Congressional Budget Act of 1974, the Director of the Congressional Budget Office has not made an estimate or comparison of the estimates of the cost of H.R. 11997, but has examined the committee's estimates and agrees with the methods and the dollar estimates resulting therefrom.

Vote of the committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 11997 was ordered reported by a voice vote.

Public Law 94-514
94th Congress, H.R. 7929[1]
October 15, 1976

An Act relating to the deduction of interest on certain corporate indebtedness to acquire stock or assets of another corporation.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (i) of section 279 of the Internal Revenue Code of 1954 (relating to interest on indebtedness incurred by a corporation to acquire stock or assets of another corporation) is amended by striking out the last sentence thereof.

(b) The amendment made by subsection (a) shall apply to taxable years ending after October 9, 1969. If refund or credit of any overpayment of income tax resulting from the amendment made by subsection (a) is prevented on the date of the enactment of this Act, or at any time within one year after such date, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within one year from such date.

Approved October 15, 1976.

[1] House Report No. 94-1345, this page; Senate Report No. 94-1266 is not published.

House of Representatives
Report No. 94-1345
2d Session

[Bracketed numerals indicate official report page numbers.]

INTEREST ON CORPORATE DEBT TO ACQUIRE ANOTHER CORPORATION

July 19, 1976

Mr. Ullman, from the Committee on Ways and Means, submitted the following report to accompany H.R. 7929.[2]

The Committee on Ways and Means, to whom was referred the bill (H.R. 7929) relating to the deduction of interest on certain corporate indebtedness to acquire stock or assets of another corporation, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

* * * * *

[3] I. Summary

Present law disallows any deduction for interest paid or incurred by a corporation, under certain circumstances, where the debt is incurred in order to acquire the stock (or assets) of another corporation. The Tax Reform Act of 1969, which enacted this provision, included a transition rule under which, if one corporation held at least 50 percent of the voting stock in another corporation on Obtober 9, 1969, then the first corporation is permitted to acquire 80-percent control (but not more) of the

[2] Public Law 94-514, this page.

second corporation without being subject to the nondeductibility provision.

This bill (H.R. 7929) eliminates the 80-percent limit. Thus, a corporation which held at least 50 percent of the voting stock in another corporation on Obtober 9, 1969, is to be allowed to acquire all the remaining stock of the second corporation without being subject to the nondeductibility provision.

II. General Statement

PRESENT LAW

Under present law, a corporation generally is allowed to deduct interest paid or incurred on its indebtedness but is not allowed a deduction for dividends paid on its stock or equity. However, under certain circumstances, a corporation is not allowed an interest deduction (either for stated interest or unstated interest such as original issue discount) for indebtedness which it issues as consideration for the acquisition of stock in another corporation, or for the acquisition of assets of another corporation (sec. 279).

A number of exceptions or modifications are provided under existing law to this interest disallowance rule. Generally the disallowance of the deduction for interest in the case of acquisition indebtedness applies to interest paid or incurred with respect to indebtedness incurred after October 9, 1969. However, this provision is inapplicable in certain cases where the issuing corporation had at least a 50-percent voting interest in another corporation on October 9, 1969, even though the obligation is issued after that date; this exception does not apply to indebtedness issued to acquire stock in excess of the amount necessary for control for tax purposes (i.e., 80 percent).

REASONS FOR THE BILL

The interest disallowance provision was added to the Code in 1969 because of a Congressional concern over the increasing number of corporate mergers in which debt, rather than equity, was being exchanged for control of acquired corporations. This trend was thought to have adverse implications for the economic well-being of the companies involved (by increasing corporate debt to dangerous levels) as well as [4] for the economy as a whole. The purpose of the exception for acquiring corporations having 50-percent or greater control of another corporation on October 9, 1969, as to permit such acquiring corporations to obtain the 80-percent control of the acquired corporation necessary for certain tax purposes.

Your committee has concluded that the 80-percent limitation imposed in connection with pre-October 10, 1969, control situations does not appear to serve the purpose of the interest disallowance provision (which is to discourage the future use of debt acquisitions under certain prescribed circumstances). This is so since the acquisition, in such cases, has already occurred. In addition, minority shareholders of a corporation which is 80-percent controlled may find themselves without a ready market for their stock, unless the controlling corporation is able and willing to purchase their shares.

EXPLANATION OF THE BILL

Under the bill, the provision denying a deduction for interest on corporate acquisition indebtedness is not to apply where a corporation which had acquired at least 50 percent of the total combined voting power of all classes of stock of another corporation by October 9, 1969, incurs acquisition indebtedness in increasing its control over the acquired corporation. Thus, the 80-percent limitation (contained in sec. 279(i) of the Code) which applies under present law in such situations, is to be removed.

EFFECTIVE DATE

The bill applies to taxable years ending after October 9, 1969.

Under the bill, any refund or credit resulting from the removal of the 80-percent limitation is not to be barred (by the statute of limitations, by *res judicata* in a litigated case, by a closing agreement, or otherwise) if the claim is filed within 1 year of the date of enactment.

III. Effect of the Bill on the Revenues and Vote of the Committee in Reporting the Bill

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made concerning the effect of this bill on the revenues. Your committee estimates that this bill will result in a one-time revenue loss of less than $1,000,000. The Treasury Department agrees with this statement.

In compliance with clause 2(1)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made concerning the vote of the committee on the motion to report the bill. This bill, as amended, was ordered reported by voice vote.

IV. Other Matters Required To Be Discussed Under House Rules

In compliance with clause 2(l)(3) of Rule XI of the Rules of the House of Representatives, the following statements are made:

With respect to subdivision (A), relating to oversight findings, it was as a result of your committee's oversight activity concerning the treatment of interest on corporate debt to acquire another corporation [5] that it concluded that the provisions of this bill are appropriate so as to eliminate possible hardship in transition situations under section 279.

With respect to subdivision (B), after consultation with the Director of the Congressional Budget Office, your committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

With respect to subdivision (C), the Director of the Congressional Budget Office has not made an estimate or comparison of the estimates of the cost of H.R. 7929, but has examined

the committee's estimates and agrees with the methods and the dollar estimates resulting therefrom.

With respect to subdivision (D), your committee advises that no oversight findings or recommendations have been submitted to your committee by the Committee on Government Operations with respect to the subject matter of H.R. 7929.

In compliance with clause 2(l)(4) of Rule XI of the Rules of the House of Representatives, your committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

Public Law 94-528
94th Congress, H.R. 1142 [1]
October 17, 1976

An act to amend the Internal Revenue Code of 1954 to provide for a distribution deduction for certain cemetery perpetual care fund, to modify the effective dates of certain provision of the Tax Reform Act of 1976, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 642 of the Internal Revenue Code of 1954 (relating to special rules for credits and deductions of estates and trusts) is amended by redesignating subsection (j) as subsection (k) and by adding after subsection (i) the following new subsection:

"(j) CERTAIN DISTRIBUTIONS BY CEMETERY PERPETUAL CARE FUNDS.—In the case of a cemetery perpetual care fund which—

"(1) was created pursuant to local law by a taxable cemetery corporation for the care and maintenance of cemetery property, and

"(2) is treated for the taxable year as a trust for purposes of this subchapter,

any amount distributed by such fund for the care and maintenance of gravesites which have been purchased from the cemetery corporation before the beginning of the taxable year of the trust and with respect to which there is an obligation to furnish care and maintenance shall be considered to be a distribution solely for purposes of sections 651 and 661, but only to the extent that the aggregate amount so distributed during the taxable year does not exceed $5 multiplied by the aggregate number of such gravesites.".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall take effect on October 1, 1977, and shall apply to amounts distributed during taxable years ending after December 31, 1963.

SEC. 2. (a) Subsection (d) of section 1204 of the Tax Reform Act of 1976 [Pub.L. 94-455] (relating to jeopardy and termination assessments) is amended by striking out "December 31, 1976" and inserting in lieu thereof "February 28, 1977".

(b) Subsection (c) of section 1205 of the Tax Reform Act of 1976 (relating to administrative summons) is amended by striking out "December 31, 1976" and inserting in lieu thereof "February 28, 1977".

(c) Subsection (e) of section 1209 of the Tax Reform Act of 1976 (relating to minimum exemption from levy for wages, salary, and other income) is amended by striking out "December 31, 1976" and inserting in lieu thereof "February 28, 1977".

(d) Subsection (c) of section 7809 of the Internal Revenue Code of 1954 (relating to deposit of collections) is amended—

(1) by striking out "and" at the end of paragraph (2) thereof;

(2) by striking out the comma at the end of paragraph (3) thereof and inserting in lieu thereof a semicolon and "and"; and

(3) by adding at the end of paragraph (3) thereof the following new paragraph:

"(4) work or services performed (including materials supplied) pursuant to section 6110 (relating to public inspection of written determinations),".

(e) The amendments made by this section shall take effect on the date of the enactment of the Tax Reform Act of 1976.

Approved October 17, 1976.

Senate Report No. 94-1317
2d Session

[Bracketed numerals indicate official report page numbers]

TAX TREATMENT OF CEMETERY PERPETUAL CARE FUND TRUSTS AND INTERNAL REVENUE SERVICE ADMINISTRATIVE MODIFICATIONS

September 28, 1976

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 1142. [1]

The Committee on Finance, to which was referred the bill (H.R. 1142) to amend the Internal Revenue Code of 1954 to provide for a distribution deduction for certain cemetery perpetual care fund trusts, having considered the same, reports favorably thereon with amendments and recommends that the bill do pass.

I. SUMMARY

The House-passed bill, H.R. 10612, provides a special deduction in computing the income of a cemetery "perpetual care fund" for amounts expended by the fund for the care and maintenance of cemetery property in which interment rights have been sold. In order to qualify as a "perpetual care fund" under this provision, the fund must be a trust established pursuant to local law by a taxable cemetery for the care and maintenance of the cemetery. The deduction allowed is to be the amount actually distributed during the year for such care and maintenance (but not more than $5 per gravesite).

The committee agreed to the House-passed bill but made the pro-

[1] Senate Report No. 94-1317, this page; House Report No. 94-1344 is not published.

[1] Public Law 94-528, this page.

visions effective October 1, 1977, for amounts distributed during taxable years ending after 1963. In addition, the committee added two amendments requested by the Internal Revenue Service which deal with certain administrative provisions enacted as a part of the Tax Reform Act of 1976 [Pub. L. 94-455]. The first amendment moves forward the effective date of three administrative provisions in the bill (jeopardy and termination assessments, administrative summons, and the minimum exemption from levy) from December 31, 1976, to February 28, 1977, [2] in order to allow the Internal Revenue Service adequate time to prepare for the administration of these provisions. The second amendment provides that the amounts received by the Internal Revenue Service as reimbursement for costs incurred in making future private letter rulings and certain other determinations available for public inspection are to be treated as reimbursable to the Internal Revenue Service appropriation.

II. General Statement

A. Cemetery Perpetual Care Trust Funds

Present law

Perpetual care funds generally are created as irrevocable trusts under State law or in accordance with the by-laws and contracts of cemetery companies. They are funded out of a percentage of the gross receipts from the sale of burial lots and crypts. The income of such a trust is applied to the perpetual care and maintenance of the cemetery, burial lots, and mausoleum crypts.

The position of the Internal Revenue Service (at least since 1964) is that a perpetual care fund trust established by a taxable cemetery is subject to tax.[1] The Service has also concluded that the deduction allowed to trusts for income distributed to their beneficiaries (under sec. 651 or 661) is not to be allowed to perpetual care funds because such funds do not have any specific beneficiaries. The Service's position in this regard is that the benefit of the trust is diffused among the owners of the lot, the cemetery companies, and the public in general.

The Court of Claims recently held (*Graceland Cemetery Improvement Fund* v. *U.S.*, 515 F. 2d 763 (Ct. Cl. 1975)) that a corporation formed for the perpetual care of a taxable cemeterly was not exempt from Federal income tax (under sec. 501(c)(13)), but was entitled to deduct as ordinary and necessary business expenses all payments made for cemetery care and upkeep.

General reasons for change

Pursuant to State law (in most cases) or legally enforceable by-laws and contracts (in the other cases), many perpetual care funds make regular distributions to taxable cemeteries for the exclusive purpose of the care and maintenance of the gravesites of such cemeteries. The Service's position is that the deduction for income distributed to beneficiaries of trusts is not allowable to perpetual care funds because they do not have any ascertainable beneficiaries.

Because distributions by perpetual care funds for the purpose of the care and maintenance of gravesites are essentially equivalent to distributions on behalf of beneficiaries (gravesite owners, heirs, and general public) the committee believes that a limited deduction should be allowed with respect to such distributions.

[3] *Explanation of provision*

The bill amends one of the trusts and estates income tax provisions (sec. 642) of present law to provide a deduction for amounts distributed by perpetual care fund trusts for the care and maintenance of gravesites. The deduction allowed is to be the amount actually distributed during the year for such care and maintenance (but not more than $5 per gravesite). Since perpetual care funds are established for the care of gravesites that have been previously sold by cemetery companies, the deduction for a taxable year is to apply only for amounts distributed to such companies for the care of gravesites sold before that taxable year. For the same reason, the deductions are to be available only with respect to those distributions for the care and maintenance of gravesites with respect to which the fund actually has an obligation of care and maintenance.

It is the committee's intent that the deduction be allowed only to the extent that the cemetery company actually expends the funds received for the care and maintenance of gravesites. Thus, if the cemetery company were to apply the funds received for instance, to the payment of officer's salaries, the perpetual care fund trust, to that extent, would not be entitled to a distribution deduction.

The bill provides that the above-described payments by a perpetual care fund trust are to be treated as distributions "solely for purposes of sections 651 and 661." As a result, in general, the gravesite owners, heirs, and general public are not to be treated as trust beneficiaries who would be required to take the distributions into income. Since the taxable cemetery company is not the beneficiary of the perpetual care fund trust, the bill does not change the treatment of the receipt of such amounts by the taxable cemetery company. Consequently, such an amount is to continue to be taxable to the cemetery company as ordinary income (sec. 61) and is not to be treated as a trust distribution in the hands of the cemetery company (secs. 652 and 662). For example, even though the perpetual care fund makes a distribution out of dividend income, tax-exempt interest, or long-term capital gains, the cemetery company is to include in income the total amount, without regard to the dividends received deduction, the exclusion of tax-exempt

[1] In Rev. Rul. 64-217 (1964-2 CB 153), the Service ruled that a perpetual care fund, the income of which is distributed to a profitmaking cemetery company for use in connection with the maintenance of cemetery sites and burial lots, is not entitled to exemption from Federal income tax under section 501(c)(13).

interest, and the deduction for half of long-term capital gains.

The provisions described above apply to a cemetery care fund only if the fund is taxable as a trust and then only if it was created pursuant to local law by a taxable cemetery corporation for the care and maintenance of cemetery property. The local law requirement relates to the governing law of the relevant jurisdiction (State, district, county, parish, city, etc.), and may take the form of a statute, ordinance, court-created doctrine or other governmental rule.

Effective date

The provision relating to the tax on cemetery perpetual care trust funds is to be effective October 1, 1977, for amounts distributed during taxable years ending after December 31, 1963. The effective date provision relates to the year in which the Service issued the ruling described above regarding the tax status of perpetual care funds of taxable cemeteries.

[4] B. INTERNAL REVENUE SERVICE ADMINISTRATION PROVISIONS

The committee also added two amendments which were requested by the Internal Revenue Service and which relate to certain administrative provisions provided by the Tax Reform Act of 1976 [Pub. L. 94-455]. The first amendment moves the effective dates forward in the case of these administrative provisions in the Tax Reform Act of 1976 in order to allow the Service more time to prepare for the administration of the revisions provided by the Act. The three provisions deal with jeopardy and termination assessments, administrative summons, and the minimum exemption from levy. In the case of each of these provisions, the effective date provided by the Acts is December 31, 1976. At the time these provisions were dealt with in both the House and the Senate during the course of the Tax Reform Act, this effective date seemed to allow the IRS adequate time to prepare for the administration of these provisions. However, since the Tax Reform Act was just recently passed by the Congress, the IRS has expressed a concern that the effective date does not allow adequate time and requested that the Service be allowed two additional months to meet the new requirements. As a result, the committee amendment extends the effective date for these three provisions from December 31, 1976, to February 28, 1977.

The second amendment deals with the reimbursement of costs incurred by the Internal Revenue Service in making future private letter rulings and certain other determinations available for public inspection. The Tax Reform Act of 1976 authorizes the IRS to assess actual costs incurred in making this information available for public inspection upon written request. However, under the provision as enacted, the fees that are charged will be paid into the general fund of the Treasury and the IRS will not be entitled to reimbursement for these costs. The committee amendment provides that fees which the IRS receives for publication of private letter rulings and other determinations may be treated as reimbursable to the IRS appropriation. The amounts received as fees will be deposited into a special account which may be used to reimburse appropriations granted to cover the costs incurred in performing these services or supplying these materials.

Effective date

The amendments relating to the administrative provisions are to take effect on the date of the enactment of the Tax Reform Act of 1976.

* * * * *

Public Law 94-530
94th Congress, H.R. 10101 [1]
October 17, 1976

An act to amend the Internal Revenue Code of 1954 to exempt certain aircraft museums from Federal fuel taxes and the Federal tax on the use of civil aircraft, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 4041 of the Internal Revenue Code of 1954 (relating to tax on special fuels) is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

"(h) EXEMPTION FOR USE BY CERTAIN AIRCRAFT MUSEUMS.—

"(1) EXEMPTION.—Under regulations prescribed by the Secretary or his delegate, no tax shall be imposed under this section on any liquid sold for use or used by an aircraft museum in an aircraft or vehicle owned by such museum and used exclusively for purposes set forth in paragraph (2)(C).

"(2) DEFINITION OF AIRCRAFT MUSEUM.—For purposes of this subsection, the term 'aircraft' means an organization—

"(A) described in section 501(c)(3) which is exempt from income tax under section 501(a),

"(B) operated as a museum under charter by a State or the District of Columbia, and

"(C) operated exclusively for the procurement, care, and exhibition of aircraft of the type used for combat or transport in World War II.".

(b) Section 6427 of such Code (relating to fuels not used for taxable purposes) is amended by redesignating subsections (d) through (h) as subsections (e) through (i), respectively, and by inserting after subsection (c) the following new subsection:

"(d) USE BY CERTAIN AIRCRAFT MUSEUMS.—Except as provided in subsection (g), if—

"(1) any gasoline on which tax was imposed by section 4081, or

"(2) any fuel on the sale of which tax was imposed under section 4041,

is used by an aircraft museum (as defined in section 4041(h)(2)) in an aircraft or vehicle owned by such mu-

[1] House Report No. 94-1359, page 556; Senate Report No. 94-1321 is not published.

seum and used exclusively for purposes set forth in section 4041(h)(2)(C), the Secretary or his delegate shall pay (without interest) to the ultimate purchaser of such gasoline or fuel an amount equal to the aggregate amount of the tax imposed on such gasoline or fuel."

(c)(1) Subsections (a)(4) and (c) of section 39 of such Code are each amended by striking out "6427(f)" and inserting in lieu thereof "6427(g)".

(2) Subsections (a), (b)(1), and (c) of section 6427 of such Code are each amended by striking out "(f)" and inserting in lieu thereof "(g)".

(3) Subsection (e)(1) of such section 6427, as redesignated, is amended by striking out "(a), (b), or (c)" and inserting in lieu thereof "(a), (b), (c), or (d)".

(4) Subsection (e)(2) of such section 6427, as redesignated, is amended by striking out "(a) and (b)" and inserting in lieu thereof "(a), (b), and (d)".

(5) Subsection (g)(2) of such section 6427, as redesignated, is amended by striking out "(d)(2)" and inserting in lieu thereof "(e)(2)".

(6) Sections 7210, 7603, 7604(b), and 7605(a) of such Code are each amended by striking out "6427(e)(2)" each place it appears and inserting in lieu thereof "6427(f)(2)".

(d) The amendments made by this section shall take effect on October 1, 1976.

SEC. 2. (a) Subsection (a) of section 4492 of the Internal Revenue Code of 1954 (defining taxable civil aircraft for purposes of the tax on the use of civil aircraft) is amended by adding at the end thereof the following new sentence: "Such term does not include any aircraft owned by an aircraft museum (as defined in section 4041(h)(2)) and used exclusively for purposes set forth in section 4041(h)(2)(C)."

(b) The amendment made by subsection (a) shall take effect on July 1, 1976.

Approved October 17, 1976.

House of Representatives Report 94-1359 2d Session

[Bracketed numerals indicate official report page numbers]

EXEMPTION FROM FUEL AND AIRCRAFT USE EXCISE TAXES FOR CERTAIN AIRCRAFT MUSEUMS

July 22, 1976

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 10101.*

The Committee on Ways and Means, to whom was referred the bill (H.R. 10101) to amend the Internal Revenue Code of 1954 to exempt certain aircraft museums from Federal fuel taxes and the Federal tax on the use of civil aircraft, and for other purposes, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

* * * * *

[3] I. SUMMARY

The bill exempts aircraft museums from the manufacturers and retailers taxes on gasoline and special fuels used for the museums' aircraft and also from the aircraft use tax on the museums' aircraft.

II. GENERAL STATEMENT

I. Exemption From Fuel Taxes (first sec. of the bill and secs. 4041 and 6427 of the Code)

Present law

Under present law (secs. 4041 and 4081) gasoline and special fuels used in noncommercial aviation, including use by aircraft museums, are subject to manufacturers and retailers excise taxes are provided where the aircraft gasoline or special fuel.[1] Exemptions from the gasoline and special fuels taxes are provided where the aircraft is used by commercial airlines, for farming, in foreign trade, by a State or local government, or by a nonprofit educational organization.[2]

Present law provides mechanisms for credits or refunds of these taxes —

(1) if the gasoline or special fuel is used by an exempt user (sec. 6416);

(2) in the case of the manufacturer's excise tax, if the gasoline is used in commercial aviation (sec. 6421(a)); and

(3) in the case of the retailers' excise taxes, if the special fuels or gasoline is used for a nontaxable purpose (sec. 6427).

The revenues from these taxes (less the credits or refunds described above) go to the Airport and Airway Trust Fund (through June 30, 1980).

Reasons for change

Several "flying aircraft museums" operate in the United States. They maintain and operate vintage airplanes either at fixed locations or at displays and airshows in various parts of the country. The aircraft are flown a limited number of times each year. The flying aircraft museums, which are exempt from income taxes,[3] are generally funded largely by membership dues and outside contributions.

A considerable part of the expense of maintaining and operating these aircraft museums consists of Federal fuels excise taxes and aircraft use taxes, despite the fact that these types of aircraft make only limited, or no use, of aircraft aids, such as radar and instrument land-[4]ing systems, provided by the Federal Government and funded through the fuels and aircraft use taxes. Your committee concluded

* Public Law 94-530, page 555.

[1] Under schedules in present law, on July 1, 1980, the manufacturers tax on gasoline is to be 1½ cents per gallon and the retailers taxes on gasoline and special fuels for noncommercial aviation are to expire

[2] An educational organization for these purposes is, in general, one which maintains a faculty and curriculum to conduct on-site education activities.

[3] Although these organizations are educational organizations, they do not maintain faculties and curricula to conduct on-site educational activities, and so do not qualify under present law for fuels taxes exemptions. See footnote 2, above.

that these flying aircraft museums should be exempt from the fuel taxes (and, as described below under item 2, from the aircraft use tax).

Explanation of provision

The bill provides an exemption from taxes on fuel in the case of aircraft museums.

Under the bill, the retailers excise tax is not to apply to gasoline or special fuels sold for use or used by an aircraft museum. Registration procedures are authorized so that the museums will be able to purchase these fuels free of the retailers taxes. Refund procedures are provided for the manufacturers excise tax on gasoline and for any retailers taxes that may have been paid on these fuels. Such refunds are to be paid, without interest, in amounts equal to the aggregate of the manufacturers and retailers excise taxes that have been paid on these fuels.

In order to qualify as an "aircraft museum" under these provisions, the organization must be exempt from income tax as an organization described in section 501(c)(3) (relating to educational, etc., organizations). Also, the organization must be operated as a museum under State (or District of Columbia) charter and must be operated exclusively for the procurement, care, and exhibition of aircraft of the type used for combat or transport in World War II.

For the exemption or refund to be available, the fuel must be used in an aircraft or vehicle (such as a ground servicing vehicle for aircraft) which is owned by an aircraft museum and is used exclusively for the procurement, care, and exhibition of aircraft of the type used for combat or transport in World War II.

Effective date

The exemption and refund provisions apply to fuel sold or used on or after October 1, 1976.

2. Exemption From Aircraft Use Tax (sec. 2 of the bill and sec. 4492 of the Code)

Present law

Present law imposes an annual excise tax upon the use of civil aircraft (through June 30, 1980). This tax (under sec. 4491) is based largely upon the weight of the aircraft.[4]

This annual use tax represents an "entry fee" to be paid each year that the aircraft uses the system (i.e., flies in the navigable air space of the United States). The amount of the tax does not depend upon the number or length of the flights. If the aircraft is flown once during the month of July, the entire year's tax must be paid. Lesser, prorated amounts are required to be paid if the first use occurs later in the year.

Your committee understands that the annual tax in the case of a B-29 (the "flying fortress" bomber used in World War II) is more than $13,000.

[5] As in the case of the fuels taxes described above, the revenues from this aircraft use tax go to the Airport and Airway Trust Fund (through June 30, 1980).

Reasons for change

For the reasons described above in connection with the fuel taxes, your committee has concluded that these flying aircraft museums should be exempt from the annual aircraft use tax.

Explanation of provision

The bill provides that an aircraft owned by an aircraft museum (described above, in the discussion regarding fuels taxes) is not subject to the aircraft use tax, so long as it is used exclusively for the procurement, care, and exhibition of aircraft of the type used for combat or transport in World War II. Any use of the aircraft other than in carrying out these purposes is a taxable use, which subjects the aircraft to the aircraft use tax as though that taxable use were the first use during the year.

Effective date

This exemption from the aircraft use tax takes effect on July 1, 1976. If a tax has already been incurred with respect to a particular aircraft because of one or more uses that are taxable under present law but that are made exempt by this bill, then (1) if the tax has not yet been paid, it is to be abated, and (2) if the tax has been paid, it is to constitute an overpayment which is to be refunded by the Treasury Department.

* * * * *

[4] The annual tax rate is $25, plus 2 cents per pound of takeoff weight over 2,500 pounds in the case of a nonturbine-powered aircraft, and 3½ cents per pound in the case of a turbine-powered aircraft.

Public Law 94-540
94th Congress, S. 1659 [1]
October 18, 1976

An Act to provide for the disposition of funds appropriated to pay a judgment in favor of the Grand River Band of Ottawa Indians in Indian Claims Commission docket numbered 40-K, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That, notwithstanding any other provision of law, the funds appropriated by the Act of October 21, 1968 (82 Stat. 1190, 1198), to pay a judgment to the Grand River Band of Ottawa Indians in Indian Claims Commission docket numbered 40-K, together with any interest thereon, after payment of attorney fees and litigation expenses and such expenses as may be necessary in effecting the provisions of this Act, shall be distributed as provided herein.

* * * * *

SEC. 6. None of the funds distributed per capita or held in trust under the provisions of this Act shall be subject to Federal or State income taxes, nor shall such funds or their availabilitiy be considered as income or other resources or otherwise utilized as the basis for denying or reducing the financial assistance or other benefits to

[1] This publication of the law is restricted to excerpts involving tax matters; Senate Report 94-577 is not published.

which such household or member would otherwise be entitled to under the Social Security Act or any other Federal or federally assisted program.

SEC. 7. The Secretary of the Interior is authorized to prescribe rules and regulations to carry out the provisions of this Act.

Approved October 18, 1976.

Public Law 94-547
94th Congress, H.R. 14041[1]
October 18, 1976

An Act to amend the Railroad Retirement Act of 1974 with respect to the computation of annuity amounts in certain cases, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, that

* * * * *

(b) Section 3231(e) of the Internal Revenue Code of 1954 is amended by striking out the second sentence and inserting in lieu thereof the following: "Such term does not include (i) the amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund, to provide for any such payment) made to, or on behalf of, an employee or any of his dependents under a plan or system established by an employer which makes provision for his employees generally (or for his employees generally and their dependents) or for a class or classes of his employees (or for a class or classes of his employees and their dependents), on account of sickness or accident disability or medical or hospitalization expenses in connection with sickness or accident disability, (ii) tips (except as is provided under paragraph (3)), (iii) the voluntary payment by an employer, without deduction from the remuneration of the employee, of the tax imposed on such employee by section 3201, or (iv) an amount paid specifically—either as an advance, as reimbursement or allowance—for traveling or other bona fide and necessary expenses incurred or reasonably expected to be incurred in the business of the employer provided any such payment is identified by the employer either by a separate payment or by specifically indicating the separate amounts where both wages and expense reimbursement or allowance are combined in a single payment.".

* * * * *

(2) The amendments made by subsection (b) of this section shall apply with respect to taxable years ending after December 31, 1953: *Provided, however,* That any taxes paid under the Railroad Retirement Tax Act prior to the date on which this Act is enacted shall not be affected or adjusted by reason of the amendments made by such subsection (b) except to the extent that the applicable period of limitation for the assessment of tax and the filing of a claim for credit or refund has not expired prior to the date on which this Act is enacted. If the applicable period of limitation for the filing of a claim for credit or refund would expire within the six-month period following the date on which this Act is enacted, the applicable period for the filing of such a claim for credit or refund shall be extended to include such six-month period.

Approved October 18, 1976.

[1] This publication of the law is restricted to excerpts involving tax matters; House Report No. 94-1465 Part I is not published.

Public Law 94-563
94th Congress, H.R. 15571[1]
October 19, 1976

An act to amend chapter 21 of the Internal Revenue Code of 1954 and title II of the Social Security Act to provide that the payment of social security taxes by a nonprofit organization with respect to its employees shall constitute (for both tax and benefit purposes) a constructive filing by such organization of the certificate otherwise required to provide social security coverage for such employees if it has not received a refund or credit of such taxes, and to require the filing of such a certificate by any nonprofit organization which paid such taxes but received a refund or credit because it had not previously filed such certificate.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 210(a)(8)(B) of the Social Security Act is amended—

(1) by inserting after "filed pursuant to section 3121(k) of the Internal Revenue Code of 1954" in the matter preceding clause (i) the following: "(or deemed to have been so filed under paragraph (4) or (5) of such section 3121(k))";

(2) by inserting after "filed" in clauses (i), (ii), and (iii) the following: "(or deemed to have been filed)"; and

(3) by striking out "is in effect" in the matter following clause (iii) and inserting in lieu thereof "is (or is deemed to be) in effect".

(b) Section 3121(b)(8) of the Internal Revenue Code of 1954 (relating to exclusion of certain services from definition of employment) is amended—

(1) by inserting after "filed pursuant to subsection (k) (or the corresponding subsection of prior law)" in the matter preceding clause (i) the following: "or deemed to have been so filed under paragraph (4) or (5) of such subsection";

(2) by inserting after "filed" in clauses (i), (ii), and (iii) the following: "(or deemed to have been filed)"; and

(3) by striking out "is in effect" in the matter following clause (iii) and inserting in lieu thereof "is (or is deemed to be) in effect".

(c) Section 3121(k) of such Code (relating to exemption of religious, charitable, and certain other organizations) is amended by adding at the

[1] House Report No. 94-1711, page 561.

end thereof the following new paragraphs:

"(4) CONSTRUCTIVE FILING OF CERTIFICATE WHERE NO REFUND OR CREDIT OF TAXES HAS BEEN MADE.—

"(A) In any case where—

"(i) an organization described in section 501(c)(3) which is exempt from income tax under section 501 (a) has not filed a valid waiver certificate under paragraph (1) of this subsection (or under the corresponding provision of prior law) as of the date of the enactment of this paragraph or any subsequent date, but

"(ii) the taxes imposed by sections 3101 and 3111 have been paid with respect to the remuneration paid by such organization to its employees, as though such a certificate had been filed, during any period (subject to subparagraph (B)(i) of not less than three consecutive calendar quarters,

such organization shall be deemed (except as provided in subparagraph (B) of this paragraph) for purposes of subsection (b)(8)(B) and section 210(a)(8)(B) of the Social Security Act, to have filed a valid waiver certificate under paragraph (1) of this subsection (or under the corresponding provision of prior law) on the first day of the period described in class (ii) of this subparagraph effective on the first day of the calendar quarter in which such period began, and to have accompanied such certificate with a list containing the signature, address, and social security number (if any) of each employee with respect to whom the taxes described in such subparagraph were paid (and each such employee shall be deemed for such purposes to have concurred in the filing of the certificate).

"(B) Subparagraph (A) shall not apply with respect to any organization if—

"(i) the period referred to in clause (ii) of such subparagraph (in the case of that organization) terminated before the end of the earliest calendar quarter falling wholly or partly within the time limitation (as defined in section 205(c)(1)(B) of the Social Security Act) immediately preceding the date of the enactment of this paragraph, or

"(ii) a refund or credit of any part of the taxes which were paid as described in clause (ii) of such subparagraph with respect to remuneration for services performed on or after the first day of the earliest calendar quarter falling wholly or partly within the time limitation (as defined in section 205(c)(1)(B) of the Social Security Act) immediately preceding the date of enactment of this paragraph (other than a refund or credit which would have been allowed if a valid waiver certificate filed under paragraph (1) had been in effect) has been obtained by the organization or its employees prior to September 9, 1976.

"(5) CONSTRUCTIVE FILING OF CERTIFICATE WHERE REFUND OR CREDIT HAS BEEN MADE AND NEW CERTIFICATE IS NOT FILED.—In any case where—

"(A) An organization described in section 501(c)(3) which is exempt from income tax under section 501 (a) would be deemed under paragraph (4) of this subsection to have filed a valid waiver certificate under paragraph (1) if it were not excluded from such paragraph (4) (pursuant to subparagraph (B)(ii) thereof) because a refund or credit of all or a part of the taxes described in paragraph 4)(A)(ii) was obtained prior to September 9, 1976; and

"(B) such organization has not, prior to the expiration of 180 days after the date of the enactment of this paragraph, filed a valid waiver certificate under paragraph (1) which is effective for a period beginning on or before the first day of the first calendar quarter with respect to which such refund or credit was made (or, if later, with the first day of the earliest calendar quarter for which such certificate may be in effect under paragraph (1)(B)(iii)) and which is accompanied by the list described in paragraph (1)(A),

such organization shall be deemed, for purposes of subsection (b)(8)(B) and section 210(a)(8)(B) of the Social Security Act, to have filed a valid waiver certificate under paragraph (1) of this subsection on the 181st day after the date of the enactment of this paragraph, effective for the period beginning on the first day of the first calendar quarter with respect to which the refund or credit referred to in subparagraph (A) of this paragraph was made (or, if later, with the first day of the earliest calendar quarter falling wholly or partly within the time limitation (as defined in section 205(c)(1)(B) of the Social Security Act) immediately preceding the date of the enactment of this paragraph), and to have accompanied such certificate with a list containing the signature, address, and social security number (if any) of each employee described in subparagraph (A) of paragraph (4) including any employee with respect to whom taxes were refunded or credited as described in subparagraph (A) of this paragraph (and each such employee shall be deemed for such purposes to have concurred in the filing of the certificate). A certificate which is deemed to have been filed by an organization on such 181st day shall supersede any certificate which may have been actually filed by such organization prior to that day except to the extent prescribed by the Secretary or his delegate.

"(6) APPLICATION OF CERTAIN PROVISIONS TO CASES OF CONSTRUCTIVE FILING.—All of the provisions of this subsection (other than subparagraphs (B), (F), and (H) of paragraph (1), including the provisions requiring payment of taxes under sections 3101 and 3111 with respect to the services involved, shall apply with respect to any certificate which is deemed to have been filed by an organization on any day under paragraph (4) or (5), in the same way they would apply if the certificate had been actually filed on that day under paragraph (1); except that—

"(A) the provisions relating to the filing of supplemental lists of con-

curring employees in the third sentence of paragraph (1)(A), and in paragraph (1)(C), shall apply to the extent prescribed by the Secretary or his delegate;

"(B) the provisions of paragraph (1)(E) shall not apply unless the taxe described in paragraph (4)(A)(ii) were paid by the organization as though a separate certificate had been filed with respect to one or both of the groups to which such provisions relate; and

"C) the action of the organization in obtaining the refund or credit described in paragraph (5)(A) shall not be considered a termination of such organization's coverage period for purposes of paragraph (3). Any organization which is deemed to have filed a waiver certificate under paragraph (4) or (5) shall be considered for purposes of section 3102(b) to have been required to deduct the taxes imposed by section 3101 with respect to the services involved.

"(7) BOTH EMPLOYEE AND EMPLOYER TAXES PAYABLE BY ORGANIZATION FOR RETROACTIVE PERIOD IN CASES OF CONSTRUCTIVE FILING.— Notwithstanding any other provision of this chapter, in any case where an organization described in paragraph (5)(A) has not filed a valid waiver certificate under paragraph (1) prior to the expiration of 180 days after the date of the enactment of this paragraph and is accordingly deemed under paragraph (5) to have filed such a certificate on the 181st day after such date, the taxes due under section 3101, with respect to services constituting employment by reason of such certificate for any period prior to the first day of the calendar quarter in which such 181st day occurs (along with the taxes due under section 3111 with respect to such services and the amount of any interest paid in connection with the refund or credit described in paragraph (5)(A)) shall be paid by such organization from its own funds and without any deduction from the wages of the individuals who performed such services; and those individuals shall have no liability for the payment of such taxes.

"(8) EXTENDED PERIOD FOR PAYMENT OF TAXES FOR RETROACTIVE COVERAGE. — Notwithstanding any other provision of this title, in any case where an organization described in paragraph (5)(A) files a valid waiver certificate under paragraph (1) by the end of the 180-day period following the date of the enactment of this paragraph as described in paragraph (5)(B), or (not having filed such a certificate within that period) is deemed under paragraph (5) to have filed such a certificate on the 181st day following that date, the taxes due under sections 3101 and 3111 with respect to services constituting employment by reason of such certificate for any period prior to the first day of the calendar quarter in which the date of such filing or constructive filing occurs may be paid in installments over an appropriate period of time, as determined under regulations prescribed by the Secretary or his delegate, rather than in a lump sum.".

(d) The amendments made by this section shall apply with respect to services performed after 1950, to the extent covered by waiver certificates filed or deemed to have been filed under section 3121(k)(4) or (5) of the Internal Revenue Code of 1954 (as added by such amendments).

SEC. 2. Notwithstanding any other provision of law, no refund or credit of any tax paid under section 3101 or 3111 of the Internal Revenue Code of 1954 by an organization described in section 501(c)(3) of such Code which is exempt from income tax under section 501(a) of such Code shall be made on or after September 9, 1976, by reason of such organization's failure to file a waiver certificate under section 3121(k)(1) of such Code (or the corresponding provision of prior law), if such organization is deemed to have filed such a certificate under section 3121(k)(4) of such Code (as added by the first section of this Act).

SEC. 3. In any case where—

(1) an individual performed service, as an employee of an organization which is deemed under section 3121(k)(5) of the Internal Revenue Code of 1954 to have filed a waiver certificate under section 3121(k)(1) of such Code, at any time prior to the period for which such certificate is effective;

(2) the taxes imposed by sections 3101 and 3111 of such Code were paid with respect to remuneration paid for such service, but such service (or any part thereof) does not constitute employment (as defined in section 210(a) of the Social Security Act and section 3121(b) of such Code) because the applicable taxes so paid were refunded or credited (otherwise than through a refund or credit which would have been allowed if a valid waiver certificate filed under section 3121(k)(1) of such Code had been in effect) prior to September 9, 1976; and

(3) any portion of such service (with respect to which taxes were paid and refunded or credited as described in paragraph (2)) would constitute employment (as so defined) if the organization had actually filed under section 3121(k)(1) of such Code a valid waiver certificate effective as provided in section 3121(k)(5)(B) thereof (with such individual's signature appearing on the accompanying list),

the remuneration paid for the portion of such service described in paragraph (3) shall, upon the request of such individual (filed in such manner and form, and with such official, as may be prescribed by regulations made under title II of the Social Security Act) accompanied by full repayment of the taxes which were paid under section 3101 of such Code with respect to such remuneration and so refunded or credited, be deemed to constitute remuneration for employment as so defined. In any case where remuneration paid by an organization to an individual is deemed under the preceding sentence to constitute

remuneration for employment, such organization shall be liable (notwithstanding any other provision of such Code) for repayment of any taxes which it paid under section 3111 of such Code with respect to such remuneration and which were refunded or credited to it.

Approved October 19, 1976.

House of Representatives
Report No. 94-1711
2d Session

[Bracketed numerals indicate official report page numbers]

SOCIAL SECURITY COVERAGE THROUGH CONSTRUCTIVE FILING OF WAIVER CERTIFICATES BY CERTAIN NONPROFIT ORGANIZATIONS

September 28, 1976

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report to accompany H.R. 15571.[1]

The Committee on Ways and Means, to whom was referred the bill (H.R. 15571) to amend chapter 21 of the Internal Revenue Code of 1954 and title II of the Social Security Act to provide that the payment of social security taxes by a nonprofit organization with respect to its employees shall constitute (for both tax and benefit purposes) a constructive filing by such organization of the certificate otherwise required to provide social security coverage for such employees if it has not received a refund or credit of such taxes, and to require the filing of such a certificate by any nonprofit organization which paid such taxes but received a refund or credit because it had not previously filed such certificate, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE OF THE BILL

The purpose of the bill is to validate the social security credits of employees of nonprofit organizations in instances in which a nonprofit organization and its employees had been paying social security taxes without having filed a valid waiver certificate to cover such employees under the social security program. The bill would provide that such a certificate would be deemed to have been filed by such an organization in those instances in which the organization did not apply for a refund of erroneously paid taxes before September 9, 1976, and those instances in which the organization does not file a waiver certificate within 180 days after enactment of the bill.

[2] GENERAL DISCUSSION

NEED FOR LEGISLATION

Under present law, employees of a nonprofit organization are excluded from social security coverage unless the organization files with the Internal Revenue Service a certificate waiving its exemption frfom taxation. Coverage may be provided retroactively for up to five years before the calendar quarter in which the waiver is filed. Employees of the organization at the time the waiver certificate is filed are given the option to participate in the program and, if they decide to do so, must sign a form accompanying the certificate waiving their right of exemption. All employees subsequently hired by the organization are automatically covered under the program. After a waiver certificate has been in effect for eight years, an organization may terminate it after giving two years advance notice.

There is substantial evidence that a large number of nonprofit organizations and their employees have been paying social security taxes even though the organizations have not filed a valid waiver certificate necessary to waive such organizations' exemption from social security tax liability and extend coverage under the program to their employees. The Internal Revenue Service has determined that such nonprofit organizations and their employees are entitled to a refund of social security taxes paid during the statute of limitations period (approximately three years) and when a refund is made the social security credits earned by an organization's employees during the statute of limitations period are cancelled.

The General Accounting Office has conducted a study of this situation and estimates that in 1975 around 13,000 to 20,000 nonprofit organizations that had not filed a waiver certificate were paying social security taxes ranging from around $118 million to $369 million. Based on the higher of the GAO estimates, the potential drain on the social security trust funds for the three year statute of limitations period, if all the organizations and their employees chose to accept refunds, would be around $1 billion. The GAO also concluded on the basis of its survey that approximately 60-65 per cent of the employees of nonprofit organizations withdrew from the social security program when given the opportunity. Thus, even if all the employing organizations chose to file waiver certificates covering the retroactive period, refunds for employees who choose not to retain their coverage could still total around $600 million.

PROVISIONS OF THE BILL

The bill would provide that in cases in which a nonprofit organization and its employees have paid social security taxes for at least three consecutive calendar quarters and continuing to within the statute of limitations period, without having filed a valid waiver certificate, but no refund or credit of such taxes has been made prior to September 9, 1976, the organization would be deemed to have filed a valid waiver certificate and a list of concurring employees representing those employees for whom social securtiy taxes were paid. This would validate the social security coverage of employees of nonprofit organizations that have been erroneously paying social security taxes without filing proper waiver certificates, both before and after enactment, with

[1] Public Law 94-563, page 558.

[3] respect to those organizations that have not received a refund credit of such taxes.

Those organizations which have received a refund or credit of taxes would have 180 days after enactment of the bill to voluntarily file a waiver certificate and a list of concurring employees. A certificate which is filed voluntarily would be effective for the first day of the period for which taxes were refunded or credited or five years before the date the certificate is filed, whichever is later.

A nonprofit organization that does not file a waiver certificate within 180 days after enactment of the bill would be deemed to have filed on the 181st day after enactment a waiver certificate for all employees for whom social security taxes were paid. A certificate which is deemed to have been filed by such an organization would be effective for the first day of the period for which a refund or credit of erroneously paid taxes was made or the first calendar quarter within the statute of limitations period, whichever is later. An organization that does not file a waiver certificate within 180 days after enactment of the bill would be solely liable for both employer and employee taxes for the retroactive period. The payment of retroactive taxes would be permitted to be made in installments and the Internal Revenue Service would have discretion to establish any reasonable period for the payment of such taxes.

It is the Committee's intent that the bill would apply to instances in which a nonprofit organization has filed a waiver certificate and subsequently submitted social security taxes for itself and its employees, but following advice received from the Internal Revenue Service, failed to file a list of concurring employees at the time it filed a waiver certificate.

Other Matters To Be Discussed Under Rules

In compliance with clause 2(l)(2)(B) of rule XI of the House of Representatives, the following statement is made relative to the vote by your committee on the motion to report the bill. The bill was ordered reported by voice vote.

In compliance with clause 2(l)(3)(A) of rule XI of the Rules of the House of Representatives, the following statement is made relative to oversight findings by your committee. As a result of an investigation conducted by the Subcommittee on Social Security, your committee concluded that it would be desirable to enact legislation to validate the social security credits of employees of nonprofit organizations that have been erroneously paying such taxes as is provided in H.R. 15571.

In compliance with clause 2(l)(3)(C) or rule XI of the Rules of the House of Representatives, your committee was advised by the Director of the Congressional Budget Office that because of the lack of relevant data, that office was unable to make a proper estimate of the potential savings arising from the enactment of H.R. 15571.

In compliance with clause 2(l)(3)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made. Enactment of H.R. 15571 would not result in any new budget authority or increased tax expenditures.

In compliance with clause 2(l)(3)(D) or rule XI of the Rules of the House of Representatives, your committee states that no oversight findings or recommendations have been submitted to your committee [4] by the Committee on Government Operations with respect to the subject matter contained in the bill.

In compliance with clause 2(l)(4) of rule XI of the Rules of the House of Representatives, your committee states that this bill would not have any inflationary impact on prices and costs in the operation of the national economy.

In compliance with clause 7 of rule XIII of the Rules of the House of Representatives, the following statement is made relative to the cost of the bill: The enactment of H.R. 15571 would not add to the cost of the social security program. The bill should result in a significant saving to the program in the form of the elimination of refunds that would otherwise be made to nonprofit organizations that have paid social security taxes erroneously. Neither the Office of the Actuary, Social Security Administration nor the Congressional Budget Office was able to furnish the Committee with a reliable estimate of the amount of such savings.

Section-by-Section Analysis of H.R. 15571

Sections 1(a)(1), (2), and (3) of the bill amend section 210(a)(8)(B) of the Social Security Act to include in the definition of employment service performed in the employ of a religious, charitable, educational, or other organization described in section 501(c)(3) of the Internal Revenue Code of 1954 which is exempt from income tax under section 501(a) of the Code during a period for which a certificate deemed to have been filed pursuant to paragraph (4) or (5) of section 3121(k) of the Code (as added by the bill) is in effect.

Sections 1(b)(1), (2), and (3) of the bill make conforming changes in section 3121(b)(8)(B) of the Code for purposes of the Federal Insurance Contributions Act.

Section 1(c) of the bill amends section 3121(k) of the Code by adding new paragraphs (4), (5), (6), (7), and (8).

The new section 3121(k)(4), entitled "Constructive filing of certificate where no refund or credit of taxes has been made," validates the social security coverage of employees of section 501(c)(3) nonprofit organizations which had been erroneously paying the taxes under sections 3101 and 3111 of the Code for their employees without filing a certificate under section 3121(k)(1) of the Code, provided no refund or credit of the erroneously paid taxes had been obtained before September 9, 1976, and the organization has paid the social security taxes during any

period of not less than 3 calendar quarters after 1950 extending until at least the end of the first quarter falling wholly or partly within the time limitation defined in section 205(c) of the Act (3 years, 3 months, and 15 days) before enactment of the bill. Such nonprofit organization will be deemed to have filed a certificate accompanied by a list containing the signature, address, and social security number, if any, of each employee for whom the taxes were paid. Each such employee will be deemed to have concurred in the filing of the certificate. The paragraph will apply to taxes erroneously paid both before and after enactment.

The new section 3121(k)(5), entitled "Constructive filing of certificate where refund or credit has been made and new certificate is not filed," provides that a nonprofit organization which has received a refund or credit of erroneously paid taxes under sections 3101 and [5] 311 of the Code prior to September 9, 1976, will be deemed to have filed a certificate for all its employees for whom taxes under sections 3101 and 3111 of the Code were paid including those for whom the taxes were refunded, unless the organization voluntarily files a certificate within 180 days after enactment of the bill. A certificate voluntarily filed under this paragraph must be effective for the first day of the period for which the taxes were refunded or credited or 5 years before the date the certificate is filed, whichever is later, and can apply to any employee of the organization who wished to be covered under social security. A certificate deemed to have been filed under this paragraph will be effective for the first day of the period for which the taxes were refunded or credited or 3 years, 3 months, and 15 days before enactment of the bill, whichever is later, and will apply to all the employees for whom the taxes were erroneously paid. A certificate deemed to have been filed under this paragraph supersedes any certificate actually filed by an organization prior to the deemed filing except to the extent prescribed by the regulations of the Secretary of the Treasury.

The new section 3121(k)(6), entitled "Application of certain provisions to cases of constructive filing," provides that the provisions of section 3121(k) of the Code, except subparagraphs (B), (F), and (H) of paragraph (1), including the provisions requiring payment of taxes under sections 3101 and 3111 of the Code, shall apply with respect to any certificate deemed to have been filed under section 3121(k)(4) or (5) of the Code, in the same way they would apply to a certificate actually filed under section 3121(k)(1) of the Code. However, the application of certain of the provisions is qualified so that:

(1) the filing of a supplemental list under the third sentence of paragraph (1)(A) or paragraph (1)(C) of section 3121(k) by an organization which has been deemed to have filed a certificate under section 3121(k)(4) or (5) of the Code applies only to the extent prescribed by the Secretary of the Treasury,

(2) If part of the employees of an organization are covered by a State or local staff-retirement system, the organization cannot divide its employees into two groups (those who are covered by the staff-retirement system and those who are not) under section 3121(k)(1)(E) of the Code when a certificate is deemed to have been filed under section 3121(k)(4) or (5) of the Code unless the taxes were paid under sections 3101 and 3111 of the Code by the organization as though a separate certificate had been filed for each group of employees,

(3) the request for refund of taxes paid under sections 3101 and 3111 of the Code by a nonprofit organization will not be considered to have been a termination of a period of coverage under section 3121(k)(3) of the Code, and

(4) any organization which is deemed to have filed a waiver certificate under section 3121(k)(4) or (5) of the Code shall be considered for purposes of section 3102(b) of the Code to have been required to deduct the taxes imposed by section 3101 of the Code with respect to the services involved.

The new section 3121(k)(7), entitled "Both employee and employer taxes payable by organization for retroactive period in cases of constructive filing," provides that in cases where a nonprofit organization [6] obtained a refund or credit of taxes and a certificate was not filed under section 3121(k)(1) of the Code in the 180-day period after enactment of the bill, the organization will be solely liable for the taxes due under sections 3101 and 3111 of the Code for the period prior to the calendar quarter in which the certificate is deemed to have been filed under section 3121(k)(5) of the Code, and the employees will have no liability for the payment of such taxes.

The new section 3121(k)(8), entitled "Extended period for payment of taxes for retroactive coverage," provides that if an organization files a certificate under section 3121(k)(1) of the Code within the prescribed 180-day period or is deemed to have filed a certificate under section 3121(k)(5) of the Code, the taxes due under sectons 3101 and 3111 of the Code for periods prior to the first day of the calendar quarter in which the certificate is actually or deemed filed may be paid in installments over an extended period of time in accordance with regulations prescribed by the Secretary.

Section 1(d) of the bill provides that the amendments made by sections 1(a), (b), and (c) shall apply to services performed after 1950 for which certificates were filed or were deemed to have been filed under section 3121(k)(4) or (5) of the Code as added by these amendments.

Section 2 of the bill provides that after September 9, 1976, no refund or credit of taxes paid under section 3101 or 3111 of the Code shall be made to a nonprofit organization which paid such taxes without filing a certificate under section 3121(k)(1) of the Code if the organization is

deemed to have filed a certificate under section 3121(k)(4) of the Code as added by the bill.

Section 3 of the bill provides that if an individual performed services for an organization which is deemed to have filed a certificate under section 3121(k)(5) of the Code as added by the bill, and if such services were performed prior to the period for which the deemed certificate is effective (but during the period for which a certificate actually filed under section 3121(k)(5)(B) would have been effective) and taxes under sections 3101 and 3111 of the Code were paid with respect to remuneration paid for such service but were refunded or credited prior to September 9, 1976, the remuneration for such services shall be deemed to constitute employment as defined in section 210(a) of the Act and section 3121(b) of the Code provided that: (1) the services would have constituted employment as so defined if the organization had filed a certificate under 3121(k)(1) of the Code with the individual's signature on the accompanying list and (2) the individual files a request, in a manner and form to be prescribed by regulations under chapter 21 of the Code, together with full repayment of the taxes paid under section 3101 of the Code with respect to such remuneration. In a case where such remuneration is deemed to constitute employment the organization shall be liable for repayment of any taxes it paid under section 3111 of the Code with respect to such remuneration and which were refunded or credited to it.

* * * * *

Public Law 94-566
94th Congress, H.R. 10210[1]
October 20, 1976

An Act to require States to extend unemployment compensation coverage to certain previously uncovered workers; to increase the amount of the wages subject to the Federal unemployment tax; to increase the rate of such tax; and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE

This Act may be cited as the "Unemployment Compensation Amendments of 1976".

TITLE I—EXTENSION OF COVERAGE PROVISIONS

PART I—GENERAL PROVISIONS

SEC. 111. COVERAGE OF CERTAIN AGRICULTURAL EMPLOYMENT.

(a) NONCASH REMUNERATION.—Section 3306(b) of the Internal Revenue Code of 1954 (defining wages) is amended by striking out "or" at the end of paragraph (9), by striking out the period at the end of paragraph (10) and inserting in lieu thereof "; or", and by adding at the end thereof the following new paragraph:

"(11) remuneration for agricultural labor paid in any medium other than cash.".

(b) COVERAGE OF AGRICULTURAL LABOR.—Paragraph (1) of section 3306(c) of such Code (defining employment) is amended to read as follows:

"(1) agricultural labor (as defined in subsection (k)) unless—

"(A) such labor is performed for a person who—

"(i) during any calendar quarter in the calendar year or the preceding calendar year paid remuneration in cash of $20,000 or more to individuals employed in agricultural labor (not taking into account labor performed before January 1, 1980, by an alien referred to in subparagraph (B)), or

"(ii) on each of some 20 days during the calendar year or the preceding calendar year, each day being in a different calendar week, employed in agricultural labor (not taking into account labor performed before January 1, 1980, by an alien referred to in subparagraph (B)) for some portion of the day (whether or not at the same moment of time) 10 or more individuals; and

"(B) such labor is not agricultural labor performed before January 1, 1980, by an individual who is an alien admitted to the United States to perform agricultural labor pursuant to sections 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act;".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to remuneration paid after December 31, 1977, for services performed after such date.

SEC. 112. TREATMENT OF CERTAIN FARMWORKERS.

(a) GENERAL RULE.—Section 3306 of the Internal Revenue Code of 1954 (relating to definitions) is amended by adding at the end thereof the following new subsection:

"(o) SPECIAL RULE IN CASE OF CERTAIN AGRICULTURAL WORKERS.—

"(1) CREW LEADERS WHO ARE REGISTERED OR PROVIDE SPECIALIZED AGRICULTURAL LABOR.—For purposes of this chapter, any individual who is a member of a crew furnished by a crew leader to perform agricultural labor for any other person shall be treated as an employee of such crew leader—

"(A) if—

"(i) such crew leader holds a valid certificate of registration under the Farm Labor Contractor Registration Act of 1963; or

"(ii) substantially all the members of such crew operate or maintain tractors, mechanized harvesting or crop-dusting equipment, or any other mechanized equipment, which is provided by such crew leader; and

"(B) if such individual is not an employee of such other person within the meaning of subsection (i).

"(2) OTHER CREW LEADERS.—For purposes of this chapter, in the case of any individual who is furnished by a crew leader to perform agricultural labor for any other person and who is not treated as an employee of such crew leader under paragraph (1)—

[1] This publication of the law is restricted to excerpts involving tax matters; Senate Report No. 94-1265, page 573; House Report No. 94-775, page 579; Conference Report No. 94-1745, page 592.

"(A) such other person and not the crew leader shall be treated as the employer of such individual; and

"(B) such other person shall be treated as having paid cash remuneration to such individual in an amount equal to the amount of cash remuneration paid to such individual by the crew leader (either on his behalf or on behalf of such other person) for the agricultural labor performed for such other person.

"(3) CREW LEADER.—For purposes of this subsection, the term 'crew leader' means an individual who—

"(A) furnishes individuals to perform agricultural labor for any other person,

"(B) pays (either on his behalf or on behalf of such other person) the individuals so furnished by him for the agricultural labor performed by them, and

"(C) has not entered into a written agreement with such other person under which such individual is designated as an employee of such other person.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to remuneration paid after December 31, 1977, for services performed after such date.

SEC. 113. COVERAGE OF DOMESTIC SERVICE.

(a) GENERAL RULE.—Paragraph (2) of section 3306(c) of the Internal Revenue Code of 1954 (defining employment) is amended to read as follows:

"(2) domestic service in a private home, local college club, or local chapter of a college fraternity or sorority unless performed for a person who paid cash remuneration of $1,000 or more to individuals employed in such domestic service in any calendar quarter in the calendar year or the preceding calendar year;".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to remuneration paid after December 31, 1977, for services performed after such date.

SEC. 114. DEFINITION OF EMPLOYER.

(a) GENERAL RULE.—Subsection (a) of section 3306 of the Internal Revenue Code of 1954 (defining employer) is amended to read as follows:

"(a) EMPLOYER.—For purposes of this chapter—

"(1) IN GENERAL.—The term 'employer' means, with respect to any calendar year, any person who—

"(A) during any calendar quarter in the calendar year or the preceding calendar year paid wages of $1,500 or more, or

"(B) on each of some 20 days during the calendar year or during the preceding calendar year, each day being in a different calendar week, employed at least one individual in employment for some portion of the day.

For purposes of this paragraph, there shall not be taken into account any wages paid to, or employment of, an employee performing domestic services referred to in paragraph (3).

"(2) AGRICULTURAL LABOR.—In the case of agricultural labor, the term 'employer' means, with respect to any calendar year, any person who—

"(A) during any calendar quarter in the calendar year or the preceding calendar year paid wages of $20,000 or more for agricultural labor, or

"(B) on each of some 20 days during the calendar year or during the preceding calendar year, each day being in a different calendar week, employed at least 10 individuals in employment in agricultural labor for some portion of the day.

"(3) DOMESTIC SERVICE.—In the case of domestic service in a private home, local college club, or local chapter of a college fraternity or sorority, the term 'employer' means, with respect to any calendar year, any person who during any calendar quarter in the calendar year or the preceding calendar year paid wages in cash of $1,000 or more for such service.

"(4) SPECIAL RULE.—A person treated as an employer under paragraph (3) shall not be treated as an employer with respect to wages paid for any service other than domestic service referred to in paragraph (3) unless such person is treated as an employer under paragraph (1) or (2) with respect to such other service."

(b) TECHNICAL AMENDMENT.—Subsection (a) of section 6157 of such Code (relating to payment of Federal unemployment tax on quarterly or other time period basis) is amended to read as follows:

"(a) GENERAL RULE.—Every person who for the calendar year is an employer (as defined in section 3306 (a)) shall—

"(1) if the person is such an employer for the preceding calendar year (determined by only taking into account wages paid and employment during such preceding calendar year), compute the tax imposed by section 3301 for each of the first 3 calendar quarters in the calendar year on wages paid for services with respect to which the person is such an employer for such preceding calendar year (as so determined), and

"(2) if the person is not such an employer for the preceding calendar year with respect to any services (as so determined), compute the tax imposed by section 3301 on wages paid for services with respect to which the person is not such an employer for the preceding calendar year (as so determined)—

"(A) for the period beginning with the first day of the calendar year and ending with the last day of the calendar quarter (excluding the last calendar quarter) in which such person becomes such an employer with respect to such services, and

"(B) for the third calendar quarter of such year, if the period specified in subparagraph (A) includes only the first two calendar quarters of the calendar year.

The tax for any calendar quarter or other period shall be computed as provided in subsection (b) and the tax as so computed shall, except as otherwise provided in subsections (c) and (d), be paid in such manner and at such time as may be provided in

regulations prescribed by the Secretary."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to remuneration paid after December 31, 1977, for services performed after such date.

SEC. 115. COVERAGE OF CERTAIN SERVICE PERFORMED FOR NONPROFIT ORGANIZATIONS AND FOR STATE AND LOCAL GOVERNMENTS.

(a) GENERAL RULE. — Subparagraph (B) of section 3309(a)(1) of the Internal Revenue Code of 1954 (relating to State law requirements) is amended to read as follows:

"(B) service excluded from the term 'employment' solely by reason of paragraph (7) of section 3306(c); and".

(b) EXCLUSION OF CERTAIN GOVERNMENT EMPLOYEES.—

(1) CERTAIN EMPLOYEES. — Paragraph (3) of section 3309(b) of such Code (relating to certain services to which section 3309 does not apply) is amended to read as follows:

"(3) in the employ of a governmental entity referred to in paragraph (7) of section 3306(c), if such service is performed by an individual in the exercise of his duties—

"(A) as an elected official;

"(B) as a member of a legislative body, or a member of the judiciary, of a State or political subdivision thereof;

"(C) as a member of the State National Guard or Air National Guard;

"(D) as an employee serving on a temporary basis in case of fire, storm, snow, earthquake, flood, or similar emergency; or

"(E) in a position which, under or pursuant to the State law, is designated as (i) a major nontenured policymaking or advisory position, or (ii) a policymaking or advisory position the performance of the duties of which ordinarily does not require more than 8 hours per week;".

(2) INMATES.—Paragraph (6) of such section 3309(b) is amended to read as follows:

"(6) by an inmate of a custodial or penal institution.".

(c) TECHNICAL ADJUSTMENTS.—

(1) Subparagraph (A) of section 3304(a)(6) of such Code is amended by striking out "except that" and all that follows down through ", and" at the end thereof and inserting in lieu thereof the following: "except that—

"(i) with respect to services in an instructional research, or principal administrative capacity for an educational institution to which section 3309(a)(1) applies, compensation shall not be payable based on such services for any week commencing during the period between two successive academic years (or, when an agreement provides instead for a similar period between two regular but not successive terms, during such period) to any individual if such individual performs such services in the first of such academic years (or terms) and if there is a contract or reasonable assurance that such individual will perform services in any such capacity for any educational institution in the second of such academic years or terms, and

"(ii) with respect to services in any other capacity for an educational institution (other than an institution of higher education) to which section 3309(a)(1) applies, compensation payable on the basis of such services may be denied to any individual for any week which commences during a period between two successive academic years or terms if such individual performs such services in the first of such academic years or terms and there is a reasonable assurance that such individual will perform such services in the second of such academic years or terms, and".

(2) Subsection (d) of section 3309 of such Code is hereby repealed.

(3) The section heading of section 3309 of such Code is amended to read as follows:

"SEC. 3309. STATE LAW COVERAGE OF SERVICES PERFORMED FOR NONPROFIT ORGANIZATIONS OR GOVERNMENTAL ENTITIES.".

(4) The table of sections for chapter 23 of such Code is amended by striking out the item relating to section 3309 and inserting in lieu thereof the following:

"Sec. 3309. State law coverage of services performed for nonprofit organizations or governmental entities.".

(5) Section 3304 of such Code is amended by adding at the end thereof the following new subsection:

"(f) DEFINITION OF INSTITUTION OF HIGHER EDUCATION.—For purposes of subsection (a)(6), the term 'institution of higher education' means an educational institution in any State which—

"(1) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate;

"(2) is legally authorized within such State to provide a program of education beyond high school;

"(3) provides an educational program for it which awards a bachelor's or higher degree, or provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and

"(4) is a public or other nonprofit institution."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to certifications of States for 1978 and subsequent years, but only with respect to services performed after December 31, 1977.

SEC. 116. EXTENSION OF FEDERAL UNEMPLOYMENT COMPENSATION LAW TO THE VIRGIN ISLANDS.

(a) AMENDMENTS OF THE SOCIAL SECURITY ACT.—Paragraph (1) of section 1101(a) of the Social Security Act is amended by inserting after the first sentence the following new sentence: "Such term when used in titles III, IX, and XII also includes the Virgin Islands.".

(b) AMENDMENTS OF THE INTERNAL REVENUE CODE OF 1954.—

(1) Section 3306(c) of the Internal Revenue Code of 1954 (defining employment) is amended by striking out "or in the Virgin Islands" in the portion of such section which precedes paragraph (1) thereof.

(2) Section 3306(j) of such Code is amended to read as follows:

"(j) STATE, UNITED STATES, AND AMERICAN EMPLOYER.—For purposes of this chapter—

"(1) STATE.—The term 'State' includes the District of Columbia, the Commonwealth of Puerto Rico, and the Virgin Islands.

"(2) UNITED STATES.—The term 'United States' when used in a geographical sense includes the States, the District of Columbia, the Commonwealth of Puerto Rico, and the Virgin Islands.

"(3) AMERICAN EMPLOYER. — The term 'American employer' means a person who is—

"(A) an individual who is a resident of the United States,

"(B) a partnership, if two-thirds or more of the partners are residents of the United States,

"(C) a trust, if all of the trustees are residents of the United States, or

"(D) a corporation organized under the laws of the United States or of any State.

An individual who is a citizen of the Commonwealth of Puerto Rico or the Virgin Islands (but not otherwise a citizen of the United States) shall be considered, for purposes of this section, as a citizen of the United States.".

(c) AMENDMENTS RELATING TO THE FEDERAL EMPLOYMENT SERVICE. —Section 5(b) of the Act entitled "An Act to provide for the establishment of a national employment system and for cooperation with the States for the promotion of such system, and for other purposes", approved June 6, 1933 (29 U.S.C. 49d (b)), is amended by striking out "Guam and the Virgin Islands" and inserting in lieu thereof "Guam".

(d) AMENDMENTS RELATING TO EXTENDED AND EMERGENCY BENEFITS.—

(1) Section 202(a)(1) of the Federal-State Extended Unemployment Compensation Act of 1970 [Pub. L. 91-373, 1970-2 C.B. 348, 355] is amended by striking out "the Virgin Islands or".

(2) Paragraph (8) of section 205 of the Federal-State Extended Unemployment Compensation Act of 1970 is amended to read as follows:

"(8) The term 'State' includes the District of Columbia, the Commonwealth of Puerto Rico, and the Virgin Islands.".

(3) Section 102(b)(1)(C) of the Emergency Unemployment Compensation Act of 1974 is amended by striking out "the Virgin Islands or".

(e) AMENDMENTS RELATING TO FEDERAL UNEMPLOYMENT COMPENSATION.—

(1) Paragraph (6) of section 8501 of title 5, United States Code, is amended to read as follows:

"(6) 'State' means the several States, the District of Columbia, the Commonwealth of Puerto Rico, and the Virgin Islands; and".

(2) Section 8503 of title 5, United States Code is amended—

(A) by striking out subsections (b) and (d);

(B) by redesignating subsection (c) as subsection (b); and

(C) by striking out "subsection (a) or (b)" in subsection (b) (as so redesignated) and inserting in lieu thereof "subsection (a)".

(3) Section 8504 of title 5, United States Code, is amended—

(A) by adding "and" at the end of paragraph (1);

(B) by striking out "; and" at the end of paragraph (2) and inserting in lieu thereof a period; and

(C) by striking out paragraph (3).

(4) Paragraph (3) of section 8521 of title 5 United States Code, is amended to read as follows:

"(3) 'State' means the several States, the District of Columbia, the Commonwealth of Puerto Rico, and the Virgin Islands."

(5) Section 8522 of title 5, United States Code, is amended by striking out "or to the Virgin Islands, as the case may be,".

(f) EFFECTIVE DATES.—

(1) SUBSECTIONS (a), (c), AND (d).—The amendments made by subsections (a), (c), and (d) shall take effect on the later of October 1, 1976, or the day after the day on which the Secretary of Labor approves under section 3304(a) of the Internal Revenue Code of 1954 an unemployment compensation law submitted to him by the Virgin Islands for approval.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply with respect to remuneration paid after December 31 of the year in which the Secretary of Labor approves for the first time an unemployment compensation law submitted to him by the Virgin Islands for approval, for services performed after such December 31.

(3) SUBSECTION (e).—The amendments made by subsection (e) shall apply with respect to benefit years beginning on or after the later of October 1, 1976, or the first day of the first week for which compensation becomes payable under an unemployment compensation law of the Virgin Islands which is approved by the Secretary of Labor under section 3304(a) of the Internal Revenue Code of 1954.

(g) TRANSFER OF FUNDS.—The Secretary of Labor shall not approve an unemployment compensation law of the Virgin Islands under section 3304(a) of the Internal Revenue Code of 1954 until the Governor of the Virgin Islands has approved the transfer to the Federal Unemployment Trust Fund established by section 904 of the Social Security Act of an amount equal to the dollar balance credited to the unemployment subfund of the Virgin Islands established under section 310 of title 24 of the Virgin Islands Code.

PART II—TRANSITIONAL PROVISIONS

SEC. 121. FEDERAL REIMBURSEMENT FOR BENEFITS PAID TO NEWLY COV-

ERED WORKERS DURING TRANSITION PERIOD.

(a) GENERAL RULE.—If any State, the unemployment compensation law of which is approved by the Secretary under section 3304(a) of the Internal Revenue Code of 1954, provides for the payment of compensation for any week of unemployment beginning on or after January 1, 1978, on the basis of previously uncovered services, the Secretary shall pay to the unemployment fund of such State an amount equal to the Federal reimbursement for any compensation paid for a week of unemployment beginning on or after January 1, 1978, to any individual whose base period wages include wages for previously uncovered services.

(b) PREVIOUSLY UNCOVERED SERVICES.—For purposes of this section, the term "previously uncovered services" means, with respect to any State, services—

(1) which were not covered by the State unemployment compensation law, at any time, during the 1-year period ending December 31, 1975; and

(2) which—

(A) are agricultural labor (as defined in section 3306(k) of the Internal Revenue Code of 1954) or domestic services referred to in section 3306(c)(2) of such Code (as in effect on the day before the date of the enactment of this Act) and are treated as employment (as defined in section 3306(c) of such Code) by reason of the amendments made by this Act, or

(B) are services to which section 3309(a)(1) of such Code applies by reason of the amendments made by this Act.

(c) FEDERAL REIMBURSEMENT.—

(1) IN GENERAL.—For purposes of this section, the Federal reimbursement for compensation paid to any individual for any week of unemployment shall be an amount which bears the same ratio to the amount of such compensation as the amount of the individual's base period wages which are attributable to previously uncovered services which are reimbursable bears to the total amount of the individual's base period wages.

(2) REIMBURSABLE SERVICES.—For purposes of determining the amount of the Federal reimbursement for compensation paid to any individual for any week of unemployment, previously uncovered services shall be treated as being reimbursable—

(A) if such services were performed—

(i) before July 1, 1978, in the case of a week of unemployment beginning before July 1, 1978; or

(ii) before January 1, 1978, in the case of a week of unemployment beginning after July 1, 1978; and

(B) to the extent that assistance under title II of the Emergency Jobs and Unemployment Assistance Act of 1974 was not paid to such individual on the basis of such services.

(3) DENIAL OF PAYMENT.—No payment may be made under subsection (a) to any State in respect of any compensation for which the State is entitled to any reimbursement under the provisions of any Federal law other than this Act or the Federal-State Extended Unemployment Compensation Act of 1970 [Pub. L. 91-373, 1970-2 C.B. 348, 355].

(d) EXPERIENCE RATING OF CERTAIN EMPLOYERS.—The unemployment compensation law of any State may, without being deemed to violate the standards set forth in section 3303(a) of the Internal Revenue Code of 1954, provide that the experience-rating account of any employer shall not be charged for the compensation paid to any individual whose base period wages includes wages for previously uncovered services which are reimbursable under subsection (c)(2) to the extent that such individual would not have been eligible to receive such compensation had the State law not provided for the payment of compensation on the basis of such previously uncovered services.

(e) CERTAIN NONPROFIT EMPLOYERS.—The unemployment compensation law of any State may provide that any organization which elects to make payments (in lieu of contributions) into the State unemployment compensation funds as provided in section 3309(a)(2) of the Internal Revenue Code of 1954 shall not be liable to make such payments with respect to the compensation paid to any individual whose base period wages for previously uncovered services which are reimbursable under subsection (c)(2) to the extent that such individual would not have been eligible to receive such compensation had the State not provided for the payment of compensation on the basis of such previously uncovered services.

(f) PAYMENTS MADE MONTHLY.—Payments under subsection (a) shall be made monthly, prior to audit or settlement by the General Accounting Office, on the basis of estimates by the Secretary of the amount payable to such State for such month, reduced or increased, as the case may be, by any amount by which the Secretary finds that his estimates for any prior month were greater or less than the amounts which should have been paid to such State. Such estimates may be made on the basis of such statistical, sampling, or other methods as may be agreed upon by the Secretary and the State.

(g) DEFINITIONS.—For purposes of this section—

(1) STATE.—The term "State" includes the District of Columbia, the Commonwealth of Puerto Rico, and the Virgin Islands.

(2) SECRETARY.—The term "Secretary" means the Secretary of Labor.

(3) BENEFIT YEAR.—The term "benefit year" means the benefit year as defined in the applicable State unemployment compensation law.

(4) BASE PERIOD.—The term "base period" means the base period as defined by the applicable State unemployment compensation law for the benefit year.

(5) UNEMPLOYMENT FUND.—The term "unemployment fund" has the meaning given to such term by section 3306(f) of the Internal Revenue Code of 1954 .

(h) AUTHORIZATION OF APPROPRIATIONS.—There are authorized to be appropriated from the general fund of the Treasury such sums as may be necessary to carry out the purposes of this section.

SEC. 122. TRANSITIONAL RULES IN CASE OF NONPROFIT ORGANIZATIONS.

(a) CREDIT FOR PRIOR CONTRIBUTIONS.—Section 3303 of the Internal Revenue Code of 1954 (relating to conditions of additional credit allowance) is amended by adding at the end thereof the following new subsection:

"(g) TRANSITIONAL RULE FOR UNEMPLOYMENT COMPENSATION AMENDMENTS OF 1976.—To facilitate the orderly transition to coverage of service to which section 3309(a)(1)(A) applies by reason of the enactment of the Unemployment Compensation Amendments of 1976, a State law may provide that an organization (or group of organizations) which elects, when such election first becomes available under the State law with respect to such service, to make payments (in lieu of contributions) into the State unemployment fund as provided in section 3309(a)(2), and which had paid contributions into such fund under the State law with respect to such service performed in its employ before the date of the enactment of this subsection, is not required to make any such payment (in lieu of contributions) on account of compensation paid after its election as heretofore described which is attributable under the State law to such service performed in its employ, until the total of such compensation equals the amount—

"(1) by which the contributions paid by such organization (or group) on the basis of wages for such service with respect to a period before the election provided by section 3309(a)(2), exceed

"(2) the unemployment compensation for the same period which was charged to the experience-rating account of such organization (or group) or paid under the State law on the basis of such service performed in its employ or wages paid for such service, whichever is appropriate.".

(b) TECHNICAL AMENDMENT. — Section 3303(f) of such Code (relating to transition to coverage of certain services) is amended by striking out "which elects, when such election first becomes available under the State law," and inserting in lieu thereof "which elects before April 1, 1972,".

(c) EFFECTIVE DATES. — The amendment made by subsection (a) shall take effect on the date on the enactment of this Act. The amendment made by subsection (b) shall take effect on January 1, 1970.

TITLE II—FINANCING PROVISIONS

SEC. 211. INCREASE IN FEDERAL UNEMPLOYMENT TAX WAGE BASE AND RATE.

(a) INCREASE IN WAGE BASE.—Paragraph (1) of section 3306(b) of the Internal Revenue Code of 1954 (defining wages) is amended by striking out "$4,200" each place it appears and inserting in lieu thereof "$6,000".

(b) INCREASE IN TAX RATE.—Section 3301 of such Code (relating to rate of Federal unemployment tax) is amended to read as follows:

"SEC. 3301. RATE OF TAX.

"There is hereby imposed on every employer (as defined in section 3306(a)) for each calendar year an excise tax, with respect to having individuals in his employ, equal to—

"(1) 3.4 percent, in the case of a calendar year beginning before the first calendar year after 1976, as of January 1 of which there is not a balance of repayable advances made to the extended unemployed compensation account (established by section 905(a) of the Social Security Act); or

"(2) 3.2 percent, in the case of such first calendar year and each calendar year thereafter;

of the total wages (as defined in section 3306(b)) paid by him during the calendar year with respect to employment (as defined in section 3306(c)).".

(e) TECHNICAL AMENDMENTS.—

(1) Suparagraph (C) of section 901(c)(3) of the Social Security Act is amended to read as follows:

"(C) Each estimate of net receipts under this paragraph shall be based upon (i) a tax rate of 0.5 percent in the case of any calendar year for which the rate of tax under section 3301 of the Federal Unemployment Tax Act is 3.2 percent, and (ii) a tax rate of 0.7 percent in the case of any calendar year for which the rate of tax under such section 3301 is 3.4 percent.".

(2) The last sentence of section 905(b)(1) of such Act is amended to read as follows: "In the case of any month after March 1977 and before April of the first calendar year to which paragraph (2) of section 3301 of the Federal Unemployment Tax Act applies, the first sentence of this paragraph shall be applied by substituting 'five-fourteenths' for 'one-tenth'.".

(3) The last sentence of section 6157(b) of the Internal Revenue Code of 1954 is amended to read as follows: "In the case of wages paid in any calendar quarter or other period during a calendar year to which paragraph (1) of section 3301 applies, the amount of such wages shall be multiplied by 0.7 percent in lieu of 0.5 percent.".

(d) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to remuneration paid after December 31, 1977.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to remuneration paid after December 31, 1976.

(3) SUBSECTION (c).—The amendments made by subsection (c) shall take effect on the date of the enactment of this Act.

SEC. 212. DENIAL OF CERTAIN PAYMENTS UNDER THE EXTENDED UNEMPLOYMENT COMPENSATION PROGRAM.

(a) IN GENERAL.—Subsection (a) of section 204 of the Federal-State Ex-

tended Unemployment Compensation Act of 1970 [Pub. L. 91-373, 1970-2 C.B. 348, 355] is amended by adding at the end thereof the following new paragraph:

"(4) The amount which, but for this paragraph, would be payable under this subsection to any State in respect of any compensation paid to an individual whose base period wages include wages for services to which section 3306(c)(7) of the Internal Revenue Code of 1954 applies shall be reduced by an amount which bears the same ratio to the amount which, but for this paragraph, would be payable under this subsection to such State in respect of such compensation as the amount of the base period wages attributable to such services bears to the total amount of the base period wages.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply with respect to compensation paid for weeks of unemployment beginning on or after January 1, 1979.

SEC. 213. ADVANCES TO STATE UNEMPLOYMENT FUNDS.

(a) ADVANCES TO BE MADE FOR 3-MONTH PERIODS.—Paragraph (1) of section 1201(a) of the Social Security Act is amended—

(1) by striking out "any month" and inserting in lieu thereof "any 3-month period";

(2) by striking out "the preceding month" and inserting in lieu thereof "the month preceding the first month of such 3-month period"; and

(3) by striking out "such month" and inserting in lieu thereof "each month of such 3-month period".

(b) APPLICATIONS.—Paragraph (2) of such section 1201(a) is amended—

(1) by striking out "any month" each place it appears and inserting in lieu thereof "any 3-month period", and

(2) by striking out "such month" each place it appears and inserting in lieu thereof "each month of such 3-month period".

(c) Section 1201(b) of such Act is amended—

(1) by inserting "in monthly installments" immediately after "transfer" where it first appears therein, and

(2) by adding at the end thereof the following new sentence: "The amount of any monthly installment so transferred shall not exceed the amount estimated by the State to be required for the payment of compensation for the month with respect to which such installment is made.".

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

SEC. 214. PRORATION OF COSTS OF CLAIMS FILED JOINTLY UNDER STATE LAW AND SECTION 8505 OF TITLE 5, UNITED STATES CODE.

(a) GENERAL RULE.—Section 8505 (a) of title 5, United States Code, is amended to read as follows:

"(a) Each State is entitled to be paid by the United States with respect to each individual whose base period wages included Federal wages an amount which shall bear the same ratio to the total amount of compensation paid to such individual as the amount of his Federal wages in his base period bears to the total amount of his base period wages."

(b) TECHNICAL AMENDMENT. — Section 8501 of title 5, United States Code, is amended by striking out "and" at the end of paragraph (6), by striking out the period at the end of paragraph (7) and inserting in lieu thereof "; and", and by adding at the end thereof the following new paragraph:

"(8) 'base period' means the base period as defined by the applicable State unemployment compensation law for the benefit year."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with regard to compensation paid on the basis of claims for compensation filed on or after July 1, 1977.

TITLE III—BENEFIT PROVISIONS

SEC. 311. AMENDMENTS TO THE TRIGGER PROVISIONS OF THE EXTENDED PROGRAM.

(a) NATIONAL "ON" AND "OFF" INDICATORS.—Subsection (d) of section 203 of the Federal-State Extended Unemployment Compensation Act of 1970 [Pub. L. 91-373, 1970-2 C.B. 348, 355] is amended to read as follows:

"(d) For purposes of this section—

"(1) There is a national 'on' indicator for a week if, for the period consisting of such week and the immediately preceding twelve weeks, the rate of insured unemployment (seasonally adjusted) for all States equaled or exceeded 4.5 per centum (determined by reference to the average monthly covered employment for the first four of the most recent six calendar quarters ending before the close of such period).

"(2) There is a national 'off' indicator for a week if, for the period consisting of such week and the immediately preceding twelve weeks, the rate of insured unemployment (seasonally adjusted) for all States was less than 4.5 per centum (determined by reference to the average monthly covered employment for the first four of the most recent six calendar quarters ending before the close of such period).".

(b) STATE "ON" AND "OFF" INDICATORS.—Subsection (e) of section 203 of such Act is amended to read as follows:

"(e) For purposes of this section—

"(1) There is a State 'on' indicator for a week if the rate of insured unemployment under the State law for the period consisting of such week and the immediately preceding twelve weeks—

"(A) equaled or exceeded 120 per centum of the average of such rates for the corresponding thirteen-week period ending in each of the preceding two calendar years, and

"(B) equaled or exceeded 4 per centum.

"(2) There is a State 'off' indicator for a week if, for the period consisting of such week and the immediately

preceding twelve weeks, either subparagraph (A) or subparagraph (B) of paragraph (1) is not satisfied.

Effective with respect to compensation for weeks of unemployment beginning after March 30, 1977 (or, if later, the date established pursuant to State law), the State may by law provide that the determination of whether there has been a State 'on' or 'off' indicator beginning or ending any extended benefit period shall be made under this subsection as if (i) paragraph (1) did not contain subparagraph (A) thereof, and (ii) the figure '4' contained in subparagraph (B) thereof were '5'; except that, notwithstanding any such provision of State law, any week for which there would otherwise be a State 'on' indicator shall continue to be such a week and shall not be determined to be a week for which there is a State 'off' indicator. For purposes of this subsection, the rate of insured unemployment for any thirteen-week period shall be determined by reference to the average monthly covered employment under the State law for the first four of the most recent six calendar quarters ending before the close of such period.".

(c) EFFECTIVE DATE.—The amendment made by subsection (a) of this section shall apply to weeks beginning after December 31, 1976, and the amendments made by subsection (b) of this section shall apply to weeks beginning after March 30, 1977.

SEC. 312. PREGNANCY DISQUALIFICATIONS.

(a) GENERAL RULE. — Paragraph (12) of section 3304(a) of the Internal Revenue Code of 1954 (relating to requirements for approval of State unemployment compensation laws) is amended to read as follows:

"(12) no person shall be denied compensation under such State law solely on the basis of pregnancy or termination of pregnancy;".

(b) TECHNICAL AMENDMENT. — Subsection (c) of section 3304 of such Code (relating to certification of State unemployment compensation laws) is amended by adding at the end thereof the following new sentence: "On October 31 of any taxable year after 1977, the Secretary shall not certify any State which, after reasonable notice and opportunity for a hearing to the State agency, the Secretary of Labor finds has failed to amend its law so that it contains each of the provisions required by reason of the enactment of the Unemployment Compensation Amendments of 1976 to be included therein, or has with respect to the 12-month period ending on such October 31, failed to comply substantially with any such provision.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to certifications of States for 1978 and subsequent years.

SEC. 313. REPEAL OF FINALITY PROVISION.

(a) GENERAL RULE.—Section 8506 (a) of title 5, United States Code, is amended by striking out the fifth sentence.

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to findings made after the date of the enactment of this Act.

SEC. 314. DENIAL OF UNEMPLOYMENT COMPENSATION TO ATHLETES, ILLEGAL ALIENS, AND RECIPIENTS OF RETIREMENT BENEFITS.

(a) GENERAL RULE. — Subsection (a) of section 3304 of the Internal Revenue Code of 1954 (relating to requirements for approval of State unemployment compensation laws) is amended by redesignating paragraph (13) as paragraph (16) and by inserting after paragraph (12) the following new paragraphs:

"(13) compensation shall not be payable to any individual on the basis of any services, substantially all of which consist of participating in sports or athletic events or training or preparing to so participate, for any week which commences during the period between two successive sport seasons (or similar periods) if such individual performed such services in the first of such seasons (or similar periods) and there is a reasonable assurance that such individual will perform such services in the later of such seasons (or similar periods);

"(14) (A) compensation shall not be payable on the basis of services performed by an alien unless such alien is an individual who has been lawfully admitted for permanent residence or otherwise is permanently residing in the United States under color of law (including an alien who is lawfully present in the United States as a result of the application of the provisions of section 203(a)(7) or section 212(d)(5) of the Immigration and Nationality Act),

"(B) any data or information required of individuals applying for compensation to determine whether compensation is not payable to them because of their alien status shall be uniformly required from all applicants for compensation, and

"(C) in the case of an individual whose application for compensation would otherwise be approved, no determination by the State agency that compensation to such individual is not payable because of his alien status shall be made except upon a preponderance of the evidence;

"(15) the amount of compensation payable to an individual for any week which begins after September 30, 1979, and which begins in a period with respect to which such individual is receiving a governmental or other pension, retirement or retired pay, annuity, or any other similar periodic payment which is based on the previous work of such individual shall be reduced (but not below zero) by an amount equal to the amount of such pension, retirement or retired pay, annuity, or other payment, which is reasonably attributable to such week;".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to certifications of States for 1978 and subsequent years, or for 1979 and subsequent years in the case of States the legislatures of which do not meet in a regular ses-

sion which closes in the calendar year 1977.

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TITLE V—MISCELLANEOUS PROVISIONS

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SEC. 506. ELECTION OF LOCAL GOVERNMENTS TO USE REIMBURSEMENT METHOD.

(a) IN GENERAL.—Paragraph (2) of section 3309(a) of the Internal Revenue Code of 1954 (relating to State law requirements) is amended—

(1) by striking out "an organization" and inserting in lieu thereof "a governmental entity or any other organization",

(2) by striking out "paragraph (1)(A)" and inserting in lieu thereof "paragraph (1)", and

(3) by striking out "that organizations" and inserting in lieu thereof "that governmental entities or other organizations".

(b) TECHNICAL AMENDMENT. — Subparagraph (B) of section 3304(a)(6) of such Code is amended by striking out "section 3309(a)(1)(A)" and inserting in lieu thereof "section 3309(a)(1)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to certifications of States for 1978 and subsequent years, but only with respect to services performed after December 31, 1977.

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TITLE VI—SPECIAL UNEMPLOYMENT ASSISTANCE AMENDMENTS

SEC. 601. EXTENSION OF SPECIAL UNEMPLOYMENT ASSISTANCE PROGRAM.

(a) Section 208 of the Emergency Jobs and Unemployment Assistance Act of 1974 is amended to read as follows:

"TERMINATION DATE

"SEC. 208. Notwithstanding any other provision of this part, no payment of assistance under this part shall be made to any individual with respect to any week of unemployment ending after June 30, 1978; and no individual shall be entitled to any assistance under this part with respect to any initial claim for assistance or waiting period credit which is effective in a week beginning after December 31, 1977.".

SEC. 602. ELIMINATION OF SPECIAL BASE PERIOD FOR PAYMENTS OF SPECIAL UNEMPLOYMENT ASSISTANCE.

(a) Paragraph (1) of section 203(a) of the Emergency Jobs and Unemployment Assistance Act of 1974 is amended by striking out *"Provided,* That" and all that follows down through "; and" at the end thereof and inserting in lieu thereof the following: *"Provided,* That the individual meets the qualifying employment and wage requirements of the applicable State unemployment compensation law in the base period; and, for purposes of this proviso, employment and wages which are not covered by the State law shall be treated as though they were covered, except that employment and wages covered by any State or Federal unemployment compensation law, including the Railroad Unemployment Insurance Act (45 U.S.C. 351 et seq.), shall be excluded to the extent that the individual is or was entitled to compensation for unemployment thereunder on the basis of such employment and wages; and".

(b) Subsection (a) of section 205 of such Act is amended by striking out "law: *Provided,* That" and all that follows down through the period at the end thereof and inserting in lieu thereof the following: "law. For purposes of the preceding sentence, employment and wages which are not covered by the applicable State unemployment compensation law shall be treated as though they were covered, except that employment and wages covered by any State or Federal unemployment compensation law, including the Railroad Unemployment Insurance Act (45 U.S.C. 351 et seq.), shall be excluded to the extent that the individual is or was entitled to compensation for unemployment thereunder on the basis of such employment and wages.".

(c) Subsection (a) of section 206 of such Act is amended by striking out "section 205: *Provided,* That" and all that follows down through the period at the end thereof and inserting in lieu thereof the folowing: "section 205. For purposes of the preceding sentence, employment and wages which are not covered by the applicable State unemployment compensation law shall be treated as though they were covered, except that employment and wages covered by any State or Federal unemployment compensation law, including the Railroad Unemployment Insurance Act (45 U.S.C. 351 et seq.), shall be excluded to the extent that the individual is or was entitled to compensation for unemployment thereunder on the basis of such employment and wages.".

(d) Subsection (a) of section 210 of such Act is amended—

(1) by striking out "and" at the end of paragraph (5); and

(2) by striking out paragraph (6) and inserting in lieu thereof the following:

"(6) 'special unemployment assistance benefit year' means the benefit year as defined by the applicable State unemployment compensation law; and

"(7) 'base period' means the base period as determined under the applicable State unemployment compensation law.".

(e) The amendments made by this section shall apply with respect to benefit years beginning after December 31, 1976. In the case of any benefit year of an individual which begins after December 31, 1976, for purposes of sections 203(a)(1), 205(a), and 206(a) of the Emergency Jobs and Unemployment Assistance Act of 1974, there shall not be taken into account any employment and wages to the extent that such individual was entitled on the basis of such employment and wages to assistance under such Act

during a benefit year beginning before January 1, 1977.

SEC. 603. DENIAL OF SPECIAL UNEMPLOYMENT ASSISTANCE TO NONPROFESSIONAL EMPLOYEES OF EDUCATIONAL INSTITUTIONS DURING PERIODS BETWEEN ACADEMIC TERMS.

(a) Section 203 of the Emergency Jobs and Unemployment Assistance Act of 1974 is amended by adding at the end thereof the following new subsection:

"(c) An individual who performs services for an educational institution or agency in a capacity (other than an instructional, research, or principal administrative capacity) shall not be eligible to receive a payment of assistance or a waiting period credit with respect to any week commencing during a period between two successive academic years or terms if—

"(1) such individual performed such services for any educational institution or agency in the first of such academic years or terms; and

"(2) there is a reasonable assurance that such individual will perform services for any educational institution or agency in any capacity (other than an instructional, research, or principal administrative capacity) in the second of such academic years or terms."

(b) The amendment made by subsection (a) shall apply to weeks of unemployment beginning after the date of the enactment of this Act.

SEC. 604. MODIFICATION OF AGREEMENTS.

The Secretary of Labor shall, at the earliest practicable date after the date of the enactment of this Act, propose to each State with which he has in effect an agreement under section 202 of the Emergency Jobs and Unemployment Assistance Act of 1974 a modification of such agreement designed to provide for the payment of special unemployment assistance under such Act in accordance with the amendments made by sections 601, 602, and 603 of this title. Notwithstanding any other provision of law, if any State fails or refuses, within the three-week period beginning on the date the Secretary of Labor proposes such a modification to such State, to enter into such a modification of such agreement, the Secretary of Labor shall terminate such agreement effective with the end of the last week which ends on or before the last day of such three-week period.

Approved October 20, 1976.

Senate Report No. 94-1265 2d Session

UNEMPLOYMENT COMPENSATION AMENDMENTS OF 1976

[Bracketed numerals indicate official report page numbers.]

September 20, 1976

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 10210.[1]

The Committee on Finance, to which was referred the bill (H.R. 10210) to require States to extend unemployment compensation coverage to certain previously uncovered workers; to increase the amount of the wages subject to the Federal unemployment tax; to increase the rate of such tax; and for other purposes, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

I. SUMMARY OF THE BILL

The bill as passed by the House of Representatives would require States to extend unemployment compensation protection to certain categories of individuals now covered only at State option and increase the Federal unemployment tax rate and increase the annual amount of wages subject to Federal and State unemployment taxes from $4,200 to $6,000 per employee. The bill would also modify the requirements for triggering the Federal-State extended benefit program into and out of operation in the States, establish a national study commission on unemployment compensation, and make a number of other changes. The committee amendments make significant revisions in the House-passed bill and add several provisions which would affect the Supplemental Security Income (SSI) program for needy aged, blind, and disabled people.

[1] Public Law 94-566, page 564.

A. COVERAGE

Employees of State and local governments.—Like the House bill, the committee bill would require the States to provide unemployment compensation coverage to all employees of State and local governments.

[2] The committee bill would make clarifying changes in the exceptions to coverage provided by the House passed bill. States would not be required to provide coverage for:

(1) Elected officials;

(2) Major non-tenured policymaking or advisory positions;

(3) Policymaking and advisory positions requiring not more than one day's employment per week;

(4) Judges;

(5) Members of a legislative body;

(6) Members of the State National Guard or Air National Guard;

(7) Emergency employees hired in case of disaster; and

(8) Inmates of custodial or penal institutions.

Under the House bill, State unemployment compensation laws would be required to contain a provision prohibiting the payment of benefits to teachers and other professional employees of schools during vacation periods who have contracts for employment in the post-vacation term, and until 1980 each State would be allowed to provide a similar prohibition for nonprofessional employees of schools who have reasonable assurance of employment in the post-vacation term.

The committee bill would modify these provisions so that vacation time unemployment benefits would not be paid to teachers and other professional

employees who have reasonable assurance of post-vacation employment even though they do not have a formal contract. In addition, the provision permitting States to prohibit vacation time unemployment benefit payments to nonprofessional school employees would be made permanent rather than be limited to a two-year period.

Each State would determine for itself how to finance the benefits which would be payable; an employing agency could be required to make periodic payments similar to the taxes paid by private employers or it could pay the actual cost of the benefits paid to its former employees. The Federal unemployment tax, though, would not be levied.

The States would not be required to provide unemployment compensation for employment prior to January 1978. However, if a State should provide the new benefits on the basis of earlier service, the cost of the resulting benefits (after January 1, 1978), would be paid with Federal funds from general revenues.

The Department of Labor estimates that $0.2 billion per year in additional unemployment compensation would be paid in fiscal 1978 and 1979 under this provision.

Employees of nonprofit elementary and secondary schools.—The bill would require the States to extend the coverage of their unemployment compensation programs to employees of nonprofit elementary and secondary schools (present law requires coverage for employees of institutions of higher education). The provisions for nonpayment of benefits during vacation periods to school employees of State and local governments would also apply to employees of nonprofit schools.

The States would not be required to provide the new coverage until January 1, 1978.

Virgin Islands.—The bill would extend the Federal unemployment compensation laws to the Virgin Islands as soon as various requirements of membership in the Federal-State system could be met.

[3] B. Financing Provisions

Tax base.—The bill would increase the Federal unemployment taxable wage base to $6,000. This change would require, in effect, that the States tax for unemployment compensation purposes the first $6,000 (rather than $4,200) in wages paid by an employer to an employee. The provision would be effective January 1, 1978.

The Department of Labor estimates that enactment of this provision would result in $2 billion of additional State taxes and $0.5 billion of additional Federal taxes (a total of $2.5 billion) for fiscal 1979.

Tax rate.—The net Federal unemployment compensation tax would be increased from 0.5 percent to 0.7 percent starting January 1, 1977, and, under the House-passed bill, ending with the earlier of (1) December 31, 1982, or (2) the end of the year in which all of the general revenue advances to the extended unemployment compensation account have been repaid. The committee bill would modify this provision so that the additional Federal tax would continue to apply until all of the advances have been repaid. The Committee estimates that this provision will result in $0.4 billion in additional revenues for fiscal year 1977.

Advances to States.—Under present law, whenever a State finds that it will not have funds available to pay unemployment compensation for any 1 month it may borrow the necessary funds from the Federal Unemployment Trust Fund. Each request for a loan can be for 1 month only. The bill would permit a single loan request to cover a 3-month period.

The change would be effective on enactment.

* * * * *

[6] E. Provisions of the House Bill Deleted by the Committee

Farm workers.—The House bill would have required the States to extend the coverage of their unemployment compensation programs to include agricultural work performed for an employer who has four or more employees in each of 20 weeks in a year or who pays wages of at least $10,000 in any calendar quarter. The committee bill does not contain any provision extending unemployment compensation to agricultural employment.

Household workers.—The House bill would have required the States to extend the coverage of their unemployment compensation programs to domestic workers employed by households that pay wages of at least $600 in any calendar quarter. The Committee bill does not include this provision.

Under present law, the coverage of domestic service in private households under the unemployment compensation program depends on the provisions of State law. The committee notes that only three States and the District of Columbia provide coverage. In the District and in New York, domestic workers are covered if the employer's quarterly payroll is $500 or more; coverage in Hawaii comes when the quarterly payroll is at least $225; and in Arkansas, employers of three or more or having a quarterly payroll of $500 are covered.

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[7] II. GENERAL EXPLANATION OF THE BILL

A. Unemployment Compensation coverage provisions

The committee bill would bring under the Federal-State unemployment compensation system the greater part of those jobs which are now exempt from the Federal unemployment tax and are consequently not now covered under State programs except to the extent that States have voluntarily elected to provide such coverage. Under the bill, employment for State and local governments and employment for nonprofit elementary and secondary schools would remain exempt from the Federal unemployment tax, but States would be required to provide coverage under State law for such jobs.

If a State did not comply with this requirement, private employers in the States would lose the tax credit they now enjoy by reason of participating in an approved State unemployment compensation program. (The credit would be equal to 2.7 percent out of the total Federal unemployment tax of 3.4 percent provided under the bill.) States would also lose Federal funding for the costs of administering their unemployment programs.

STATE AND LOCAL GOVERNMENT EMPLOYEES

(Sec. 101 of the Bill)

Under present Federal laws, the States are required to provide unemployment insurance for employees of State operated hospitals and institutions of higher education. In addition, more than one-half of the States have gone beyond the Federal requirements and provide mandatory coverage for State employees and permit local governments to opt for coverage. Nine States, Connecticut, Florida, Hawaii, Iowa, Michigan, Minnesota, Montana, Ohio, and Oregon require coverage of both State and local government employment. The committee bill would require coverage of all State and local employees.

[8] UNEMPLOYMENT COMPENSATION COVERAGE UNDER PRESENT LAW AND THE COMMITTEE BILL [1]

	Employment—Numbers (in thousands)
Covered under present law	72,385
Under State programs	66,700
Federal employees/ military	5,093
Railroad	592
Added to coverage under H.R. 10210	7,946
State government	600
Local government	7,100
Nonprofit organizations	242
Virgin Islands	4

[1] Based on most recent data (1974) modified to reflect some modification of coverage since that time.

Provisions of committee bill.—Under the committee bill State and local government employment would continue to be exempt from the Federal unemployment payroll tax. States would, however, be required to provide State coverage for such employment as a condition of continued participation in the Federal-State unemployment compensation program. (Failure to participate would, in effect, raise the Federal unemployment tax on employers in the State from 0.7 to 3.4 percent and would deprive the State of Federal funds to meet administrative expenses and part of the benefit costs for benefits paid after the 26th week of unemployment.)

All State and local government employees would have to be covered except elected officials, major nontenured policy-making and advisory employees, policy-making and advisory employees who do not work on more than one day each week, judges, members of the legislature, members of the National Guard, prisoners, and persons hired for temporary jobs in emergency situations. With the above exceptions, all employment after December 31, 1977 would be covered. Under the bill, the State law could permit the employing entity to pay for its coverage either through contributions equivalent to the State payroll tax or by reimbursing the fund for benefits paid to its former employees.

Constitutionality.—Generally, mandatory Federal coverage under the Federal-State unemployment compensation program exists by virtue of applying the Federal unemployment payroll tax to the employment in question. It then becomes of no advantage not to cover that employment under the State program since failure to do so would eliminate the 2.7-percent Federal tax credit which would otherwise apply. In the case of State and local government employment, however, such a procedure would raise questions of the power of the Federal Government under the Constitution to lay a tax upon a vital State function. Consequently, the bill would continue to exempt State and local employment from the Federal tax but would require coverage for such employment as a condition of approving the State program. This [9] type of mandatory Federal coverage was applied in the 1970 amendments to require States to provide unemployment compensation protection to employees of State hospitals and State institutions of higher education.

A recent Supreme Court decision (*National League of Cities* v. *Usery*) invalidated provisions of the 1974 Fair Labor Standards Amendments which had extended minimum wage coverage to State and local government employees. The Solicitor of the Department of Labor has issued an opinion holding that that decision is not applicable to the H.R. 10210 provisions extending unemployment compensation coverage to such employees.

Coverage of school employees during vacation periods.—Under present law, States are required to provide coverage for employees of State institutions of higher education with benefits payable under the same conditions as apply to other individuals covered under the program except that no benefits are payable during a summer vacation (or similar period between terms) to persons in academic or principal administrative positions who have contracts for the following term (whether or not at the same institution). The House bill, which extends coverage to all State and local employees, would make this provision applicable to such employees regardless of type of school. In addition, the House bill permits States to deny benefits to nonprofessional employees during vacation periods if they have reasonable assurance of continuing in that employment in the following term. Starting in 1980, however, this option would expire and State and local governments would have to provide benefits during the vacation period to nonprofessional employees who cannot find employment during that time.

The committee bill would modify these provisions so that a teacher or professional employee could not qualify for unemployment compensation

during vacation periods when there is a reasonable assurance that a job will be available for the post-vacation term (even if a formal contract has not been signed). In making this change, the committee intends that the determining factor be the availability of a job to the individual—whether or not the individual wishes to accept the job. If a job is available to the individual and he does not want to accept it, he would be disqualified just as any other individual who refuses employment is disqualified.

The provision of the House bill which permits the States to deny benefits during vacation periods to nonprofessional school employees for a 2-year period would under the committee bill be a permanent option for the States.

NONPROFIT ORGANIZATIONS

(Sec. 101 of the Bill)

Elementary and secondary schools.—Prior to the 1970 amendments, nonprofit organizations, which are exempt from taxation under the Internal Revenue Code, were covered as employers for unemployment compensation purposes only at the option of the States. The 1970 amendments required States to provide coverage for nonprofit employers who have at least four employees in at least 20 weeks of the year. However, an exception in the law allows States to exclude from [10] coverage nonprofit elementary and secondary schools. The committee bill would repeal this exclusion, thus requiring coverage for such schools on the same basis as it is required for other nonprofit entities.

Special provision for certain nonprofit employers.—When the 1970 amendments required the extension of coverage to nonprofit employers, a provision was also added allowing such organizations to pay for their coverage by reimbursing the State unemployment fund for any benefits paid to their former employees (on the basis of such employment). If they chose this option, they would not be required to pay the State unemployment taxes otherwise applicable. The 1970 amendments also permitted any nonprofit entity which had been covered prior to those amendments to switch to this reimbursement method of paying for its coverage and to take credit for any past State unemployment taxes it had paid in excess of what it would have paid under the reimbursement method. This opportunity was available, however, only if permitted by State law and only if the nonprofit employer made an election to change to the reimbursement method at the first opportunity.

The Hoag Memorial Hospital in California had elected and later terminated unemployment compensation coverage for its employees prior to the 1970 amendments which made such coverage mandatory as of January 1972. However, since the hospital did not have unemployment coverage in effect during the period between the enactment of the 1970 amendments and January 1972 when coverage became mandatory, its election of the reimbursement method did not take place at the earliest time possible under State law, namely in 1971. As a result, the hospital was barred from claiming the credit which would otherwise have been allowed for the excess of its past contributions over the benefit payments made to its former employees. A provision in H.R. 10210 would allow that institution (and any other nonprofit organization which may be in similar circumstances) to claim the retroactive credit provided that it elected the reimbursement method by April 1, 1972.

A provision similar to that adopted in 1970 allowing nonprofit employers to take credit for past excess contributions is included in H.R. 10210 for the nonprofit schools for which coverage is mandated by the bill.

TRANSITIONAL FEDERAL FUNDING PROVISIONS

(Sec. 121 of the Bill)

Costs of State and local coverage.—The provisions of the bill which would extend coverage under the unemployment compensation program to some 588,000 State employees who are not now covered and to about 7.7 million employees of local governments. State programs would be required to pay benefits on the basis of employment taking place after December 31, 1977. If States elect to pay benefits on the basis of this previously uncovered employment prior to that date, the costs of any such benefits payable after January 1, 1978, would be reimbursed from Federal general revenues. (Federal reimbursement would also be made for benefits paid prior to July 1, 1978, on the basis of State or local employment during the first 6 months of 1978.) Because some of this earlier coverage could also include employment [11] which would qualify for payments under the federally funded Special Unemployment Assistance (SUA) program, the committee adopted an amendment to make clear that Federal reimbursement for regular unemployment benefits based on such employment will be available only to the extent that Federal SUA benefits were not paid on the basis of the same employment. The table below indicates the benefits which would be paid as a result of the State and local coverage provisions of H.R. 10210.

ESTIMATED UNEMPLOYMENT BENEFIT PAYMENTS BASED ON STATE AND LOCAL GOVERNMENT EMPLOYMENT COVERED BY H.R. 10210

[In millions]

Fiscal year	Total unemployment benefit payments [1]	Amount reimbursable from Federal general funds [2]
1978	$200	$190
1979	210	50
1980	230	0
1981	260	0

[1] Includes regular and extended benefits.

[2] Under special provision where States provide benefits on the basis of employment prior to July 1, 1978.

Costs of coverage for non-profit schools.—The Department of Labor estimates that the bill's provisions requiring coverage for employees of non-profit elementary and secondary schools will result in additional benefit payments of $10 million in each of the fiscal years 1978-1981. In fiscal year 1978, $8 million of this total would be paid for from Federal general revenues under the bill's special start-up provisions.

INCLUSION OF VIRGIN ISLANDS IN THE FEDERAL-STATE UNEMPLOYMENT INSURANCE SYSTEM

(Sec. 102 of the Bill)

Under existing Federal law, the Virgin Islands is excluded from the Federal-State system of unemployment insurance. The Virgin Islands has for several years had a similar unemployment insurance program, however, and the territorial government has formally requested that the Virgin Islands be included in the Federal-State system.

The inclusion of the Virgin Islands in the Federal-State unemployment system as proposed in the bill would extend to that jurisdiction the Federal unemployment tax and thus increase slightly the revenues to the Federal accounts in the unemployment trust fund. At the same [12] time, it would provide new or modified funding for the Virgin Islands programs as shown in the table below.

FUNDING CHANGES FOR VIRGIN ISLANDS UNEMPLOYMENT PROGRAM UNDER THE COMMITTEE BILL

Expenditure type	Current funding	Funding under H.R. 10210
Regular benefits	Territorial tax	Territorial tax.
Administrative costs:		
Compensation system.	do	Federal trust fund accounts.
Employment service.	Federal general funds.	Federal trust fund accounts and general funds.
Extended benefits	Not in effect	50 percent territorial tax, 50 percent Federal trust fund accounts.
Loans	Federal general funds.	Federal trust fund accounts.

Loans to the Virgin Islands.—Under the Federal-State unemployment compensation system, States which exhaust their own benefit funds may borrow from the Federal accounts in the trust fund to meet their benefit obligations. The Virgin Islands is unable to use this procedure since it is not now a part of the Federal-State system. In Public Law 94-45 [1975-2 C.B. 513], authority was provided for loans to be made to the Virgin Islands for this purpose. Under that legislation and subsequent amendments, the Virgin Islands is authorized to borrow up to $15 million which must be repaid by January 1, 1979. The law authorizing these loans also provides that the repayment requirements of the Federal-State unemployment compensation program will come into operation if the Virgin Islands is incorporated into that system as proposed in the committee bill. As of July 1976, the Virgin Islands system has borrowed $5.6 million under the authority of Public Law 94-45.

B. Financing Provisions

INCREASES IN THE UNEMPLOYMENT TAXES

(Sec. 201 of the Bill)

Financing basis. The Federal statute now imposes a gross tax of 3.2 percent of covered wages. The tax base or maximum amount of annual wages per employee subject to this tax is $4,200. (In 1974, the average annual wage in covered employment was about $9,200.) Although the gross Federal tax rate is 3.2 percent, the actual net Federal tax rate is 0.5 percent since employers qualify for a 2.7-percent [13] tax credit by reason of their participation in an approved State program. Thus, the Federal tax in all States amounts to 0.5 percent of the first $4,200 of wages. The proceeds from this Federal tax are used to meet the costs of administering the unemployment compensation program—including both Federal and State costs—most of the cost of administering public employment serv-

ices, half of the cost of benefit payments under the extended benefit program (for workers exhausting their regular benefits), and all of the cost of the temporary emergency benefit program (for workers exhausting both regular and extended benefits).

The cost of regular State benefits and half the cost of extended benefits are met from the proceeds of State unemployment taxes. The tax base to which State taxes apply is effectively required to be at least as high as the Federal base of $4,200, but 22 States now have bases which exceed that level. The tax rate applied in each State may vary from year to year according to conditions and may vary among different employers according to experience rating factors which are designed to allow employers a lower tax if their employees do not experience much unemployment. Because of the heavy use of unemployment benefits during the recent recessionary period, the average State tax rate has increased from 1.9 recent in 1974 to an estimated 2.5 percent in 1976. Among the States, the estimated average tax rate applied to taxable wages varies from 0.6 percent in Texas to 4.1 percent in Massachusetts.

The need for additional financing.—If the State tax revenues prove insufficient to meet benefit obligations in times of high unemployment States are permitted to borrow the necessary funds from the Federal accounts in the trust fund. If the Federal accounts have insufficient funds to meet State borrowing requests and to cover the Federal responsibility for paying half the cost of extended benefits and all the costs of emergency benefits, authority is available for repayable advances from the general funds of the Treasury into the Federal accounts of the trust fund. Because of the heavy demands on the unemployment compensation system made by the high levels of unemployment in the past few years and by the enactment of temporary legislation providing benefits of up to 65 weeks duration, the unemployment payroll taxes—both Federal and State—have proven unable to meet expenses. As of the beginning of fiscal year 1977, advances from the general fund will amount to about $10.9 billion which is estimated to increase to $14.5 billion by the end of fiscal year 1978. Advances have been made to 21 States and total $3.1 billion.

Provisions of the committee bill.—The committee bill would increase the gross Federal unemployment tax rate from 3.2 percent to 3.4 percent while leaving the tax credit at 2.7 percent. This raises the net Federal tax by 0.2 percent, that is, from the present level of 0.5 to a new level of 0.7 percent. Under the House bill, this increased tax rate would take effect in January 1977 and would continue in effect through 1982 after which the existing 0.5 percent net tax rate would again become applicable. The House bill also provides that the tax rate will revert to 0.5 percent at an earlier date if the advances from the general fund have been repaid.

* * * * *

[16] Information furnished to the committee by the Department of Labor indicates that the additional income resulting from the higher tax rate will not be sufficient to pay back even a major part of the advances by 1982. In the 5-year period for which the increased tax rate would be in effect under the House bill, the deficit would be reduced from the present $7.7 billion to about $5 billion. The committee bill would keep the higher Federal tax rate in effect after 1982 until the entire deficit has been repaid.

The increase in the Federal tax rate will affect only the amounts collected by the Federal trust fund accounts. The committee bill also increases the amount of annual earnings subject to taxation from $4,200 to $6,000. This increase is effective January 1978 and would affect both Federal and State taxes. Since States have the ability to adjust their tax rates within the overall base, the exact impact of the increase on State revenues is difficult to estimate. The following table, however, presents the estimated effect on both State and Federal unemployment revenues under the provisions in the House bill.

IMPACT OF TAX PROVISIONS

[In billions of dollars]

	Increased revenue under H.R. 10210		
	Federal		
Fiscal year	From higher tax rate [1]	From higher wage base [1]	State
1977	[2]0.3		
1978	.5	0.2	0.4
1979	.8	.5	1.6
1980	.8	.5	2.6
1981	.8	.5	2.8

[1] Revenues shown as attributable to tax rate increase are those which would result if there were no increase in the wage base. Revenues attributable to the wage base increase would be somewhat smaller if there were no concurrent increase in the tax rate.

[2] In action on the Second Concurrent Resolution on the Budget for 1977, the Congress assumed that revenues would be increased by $0.4 billion as a result of this provision. The difference in the Labor Department estimate is attributable to differences in economic assumptions. The committee accepts the $0.4 billion estimate underlying the Budget Resolution.

Source: Department of Labor.

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House of Representatives
Report No. 94-755
1st Session

[Bracketed numerals indicate official report page numbers.]

UNEMPLOYMENT COMPENSATION AMENDMENTS OF 1975

December 16, 1975

Mr. ULLMAN, from the Committee on Ways and Means, submitted the following report together with supplemental, additional, dissenting, and minority views to accompany H.R. 10210.[1]

The Committee on Ways and Means to whom was referred the bill (H.R. 10210) to require States to extend unemployment compensation coverage to certain previously uncovered workers; to increase the amount of the wages subject to the Federal unemployment tax; to increase the rate of such tax; and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

* * * * *

I. SUMMARY

The Unemployment Compensation Amendments Act of 1975 (H.R. 10210) is designed to achieve the following objectives:

provide coverage under the permanent Federal-State Unemployment Compensation law for substantially all the nation's wage and salary earners and thereby eliminate the need for the temporary Special Unemployment Assistance program;

restore solvency in the Unemployment Compensation program at the State and Federal levels by increasing revenues in a manner that distributes fairly the impact of additional employer-paid taxes;

modify the "trigger mechanism" in the Extended Benefits program; and

establish a National Study Commission that will undertake a thorough and comprehensive examination of the present Unemployment Compensation program and make recommendations for further improvements.

The Unemployment Compensation program was enacted during the great depression of the 1930's, as part of the Social Security Act of 1935 [P.L. No. 271, XIV-2 C.B. 539]. The primary objectives of the program are to provide workers with sufficient income to meet non-deferable expenses during periods of temporary unemployment and to help stabilize the economy during periods of economic decline. For 40 years, Unemployment Compensation has provided financial protection against temporary unemployment for most of the nation's workers. It is an important source of security for the employed and the major source of assistance for jobless workers. The Unemployment Compensation program has been a major factor in preventing recent economic conditions from reaching the disastrous proportions of the great depression.

Current economic conditions have placed considerable strain on the Unemployment Compensation system and led to the enactment of temporary programs providing additional coverage and benefits. The necessity and basic soundness of the program have been clearly demonstrated during the recent months of high unemployment. Some inadequacies and needed improvements have also been emphasized. The Unemployment Compensation Amendments Act of 1975 makes important improvements in the program and establishes a National Study Commission with the directive to thoroughly examine the Unemployment Compensation system and recommend additional improvements.

Extending Coverage

There are about 80 million wage and salary workers in the nation today. Approximately 68 million are currently covered under permanent State and Federal unemployment compensation programs. The remaining 12 million workers are not covered, or do not have unem-[2]ployment protection, under existing *permanent* law. The major groups of workers without permanent coverage are State and local government employees, agricultural employees and domestic workers.

Three states—New York, Arkansas, and Hawaii—and the District of Columbia already provide coverage under their permanent programs for domestic workers. Minnesota, Hawaii, Puerto Rico, and the District of Columbia cover farm workers. Farm workers in California will be covered as of January 1, 1976. Twenty-nine states cover substantially all state government employees, and eight states cover local government workers. In states where these workers are not covered under the permanent program, they are currently provided limited unemployment benefits under the temporary Special Unemployment Assistance (SUA) program due to expire December 31, 1976.

In order to provide equal treatment of all the nation's wage and salary workers under the permanent unemployment compensation law and eliminate the need to provide unemployment protection for uncovered workers on a temporary and emergency basis, H.R. 10210 makes the following changes in the permanent Federal-State unemployment compensation programs.

1. Coverage is extended to agricultural workers of employers with 4 or more workers in 20 weeks or who paid $5,000 in any calendar quarter.

2. Coverage is extended to domestic workers of employers who paid $600 or more in any calendar quarter for domestic services.

3. Coverage is extended to State and local government employees with the following exceptions: elected officials or officials appointed for a specific term or on a part-time basis; members of a legislative body or the judiciary; members of the State National Guard or Air National Guard; emergency employees hired in case of disaster; and inmates of custodial or penal institutions.

4. Coverage is extended to employees of non-profit elementary and secondary schools.

[1] Public Law 94-566, page 564.

Other coverage provisions in H.R. 10210 include the following:

5. Non-resident aliens admitted to the United States to perform agricultural work under the Immigration and Nationality Act are excluded from coverage for 2 years.

6. The farm operator is deemed the employer of farm labor supplied by a crew leader, unless the crew leader is registered under the Farm Labor Contractor Registration Act, or substantially all the workers supplied by the crew leader operate or maintain tractors, harvest equipment, cropdusting equipment, or other mechanized equipment.

7. Payment of benefits based on services performed for educational institutions in instructional, research, or principal administrative capacities are prohibited during periods between academic years or terms if an individual has a contract to perform such services for both the prior and forthcoming terms.

For two years, States are permitted to deny benefits based on services performed for educational institutions during periods between school terms to non-professional employees of primary, secondary and vocational educational institutions if an individual was employed at the end of the prior term and there is reasonable assurance he or she will be so employed during the forthcoming terms.

8. A transitional period is provided with the objective of eliminating [3] a gap in protection between the termination of the Special Unemployment Assistance (SUA) program and the beginning of coverage of agricultural workers, domestic workers, and State and local government employees under the permanent U.C. program.

9. The Virgin Islands is permitted to become a part of the Federal-State Unemployment Compensation system.

These provisions extend unemployment compensation coverage under the permanent Federal-State system to about 9.5 million of the 12 million jobs not presently covered: 7.7 million local government, 0.6 million State government, 0.7 million farm jobs, and 0.4 million domestic jobs. The Department of Labor estimates that the coverage and transition provisions of H.R. 10210 will increase unemployment compensation expenditures under the permanent programs by approximately $1,350 million in fiscal 1978: $800 million for Regular State benefits, $200 million for Federal-State Extended Benefits, and $350 million for transition from SUA to U.C.

Restoring Solvency to the U.C. Trust Funds

The Unemployment Compensation system is no longer self-supporting. The financial structure of the system at both the State and Federal levels is seriously threatened. As of December 15, 1975, 15 states had depleted their U.C. funds and as many as 30 will be forced to borrow from the Federal Government by the end of calendar year 1976. The Department of Labor estimates that, under present financing provisions, the State U.C. trust funds will have deficits totalling $16.5 billion in 1978, increasing to $24.1 billion in 1984.

The Federal Unemployment Account (from which the States with depleted trust funds borrow money) and the Extended Unemployment Compensation Account (which financed the Federal share of the Extended Benefits program) are both depleted and borrowing Federal general revenues. The Department of Labor projects that, under the existing tax base and net Federal tax rate, the Federal U.C. trust funds will have a deficit of $6.2 billion in 1978 increasing to $9.6 billion in 1984.

With the objectives of restoring fiscal solvency at the State and Federal levels as soon as possible and distributing equitably the needed increases in employer payroll taxes, H.R. 10210 makes the following changes in the existing financing provisions:

1. The taxable wage base is increased from $4,200 to $8,000 for both Federal and State U.C. taxes.

2. The net Federal U.C. tax rate is increased from 0.5 percent to 0.7 percent. It is reduced to 0.5 percent in 1982 or the year after all advances to the Federal extended unemployment compensation account have been repaid, whichever occurs first.

Other financing provisions in H.R. 10210 include the following:

3. In determining the Federal grants for administrative expenses, reimbursement will not be allowed from FUTA revenues for administrative costs attributable to State and local government employees.

4. The definition of "sharable benefits" under the Federal-State extended benefits program is revised to eliminate any sharing of payments by the Federal Government based upon services performed by workers in State and local governments.

5. States are allowed to request loans from the Federal unemployment trust funds to pay benefits for a 3-month period, rather than the 1-month period under current law.

[4] 6. When an individual's U.C. benefits are based on both Federal and non-Federal employment, the Federal share of the cost will be based on the ratio of Federal wages to total base period wages, rather than the "added cost" method under current law.

7. States will be reimbursed from Federal general revenues for U.C. benefits paid to CETA public service employees.

The increased tax base and net Federal tax rate contained in this bill will raise an additional $1.6 billion in Federal unemployment compensation revenues in fiscal 1978, and make it possible to achieve a positive balance in the Federal U.C. Trust Funds by 1981. How much additional revenue the higher tax base will produce at the State level depends largely on the rate structure established in each state. Assuming an average tax rate in the states of 2.7 percent, the $8,000 base would increase State U.C. revenues by about $4.7 billion in fiscal 1978 and produce a positive balance in the U.C. trust funds of most States by 1981.

* * * * *

TITLE I—EXTENSION OF COVERAGE PROVISIONS

Item	H.R. 10210—Subcommittee bill	Current law
1. Extension of coverage to agricultural workers.	Extends coverage to agricultural workers of employers with four or more workers in 20 weeks or who paid $5,000 in wages in any calendar quarter. (Secs. 111 and 114.)	Coverage of agricultural workers is not mandatory under present Federal law. Agricultural workers are covered in the District of Columbia, Minnesota, Hawaii, Puerto Rico, and California (effective Jan. 1, 1976). (IRC Secs. 3306(c)(1); 3306(k).)

Item	H.R. 10210—Subcommittee bill	Current law
2. Exception to agricultural coverage.	Excludes from coverage for 2 years non-resident aliens admitted to the United States to perform agricultural work under sections 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act. (Sec. 111.)	No relevant provisions
3. Identification of agricultural employer.	Deems the farm operator the employer if farm labor is supplied by a crew leader, unless the crew leaedr is registered under the Farm Labor Contractor Registration Act; or substantially all the workers supplied by the crew leader operate or maintain tractors, harvest equipment, cropdusting equipment, or other mechanized equipment. (Sec. 112.)	Since UC coverage of agricultural workers is not mandatory under present Federal law, there are no corresponding provisions. For purposes of social security benefits, crew leaders generally are deemed to be the employers, and thereby responsible for collecting and reporting OASDI taxes. (SSA Title II Sec. 210(n).)
4. Extension of coverage to domestic workers.	Extends coverage to domestic workers of employers who paid $600 or more in any calendar quarter for domestic services. (Sec. 113 and 114.)	Coverage of domestic workers is not mandatory under present Federal law. Domestic workers are covered in the District of Columbia and New York if the employer's quarterly payroll for domestic service is at least $500; Hawaii if the employer's quarterly payroll is at least $225; and Arkansas if the employer's quarterly payroll is $500 or he employes three or more domestic workers. (IRC Sec. 3306(c)(2).)
5. Extension of coverage to State and local government employees.	Extends coverage to State and local government employees with the following exceptions: (1) elected officials or officials appointed for a specific term or on a part-time basis; (2) members of a legislative body or the judiciary; (3) members of the State National Guard or Air National Guard; (4) emergency employees hired in case of disaster; and (5) inmates of custodial or penal institutions. (Sec. 115.)	Coverage of State government employees of hospitals and institutions of higher education is mandatory. Coverage of other State and local government employees is left to the option of the States. Twenty-nine States cover substantially all State government employees and eight States cover most local government employees. (IRC, Sec. 3309(a)(1); Sec. 3304(a)(6)(A); Sec. 3306(c)(7).)
6. Eligibility of employees of educational institutions during the summer months.	Prohibits payment of benefits based on services performed for educational institutions in instructional, research, or principal administrative capacities during periods between academic years or terms if an individual has a contract to perform such services for both the prior and fothcoming terms. (Sec. 115.). Permits States, for 2 years, to deny benefits based on services performed for educational institutions during the periods between school terms to nonprofessional employees of primary, secondary and vocational educational institutions if an individual was employed at the end of the prior term and there is reasonable assurance he or she will be so employed during the forthcoming terms. (Sec. 115).	Federal law requiring State coverage of employees in higher education provides for denial of benefits based on services performed for such institutions during periods between terms to employees in instructional, research or principal administrative capacities, if the individual has a contract for both the prior and forthcoming terms. (IRC Sec. 3304(a)(6)(A).)

TITLE I—EXTENSION OF COVERAGE PROVISIONS—Continued

Item	H.R. 10210—Subcommittee bill	Current law
7. Extension of coverage to employees of nonprofit educational institutions.	Extends coverage to employees of nonprofit elementary and secondary schools. (Sec. 115.)	Coverage of nonprofit elementary and secondary school employees is not mandatory under present Federal law. Coverage is required for certain other nonprofit organizations (including institutions of higher education) which employ four or more workers in 20 weeks. (IRC Sec. 3309(c); 3306(c)(8).)
8. Inclusion of the Virgin Islands in the Federal-State unemployment compensation system.	Permits the Virgin Islands to become part of the Federal-State U.C. system. (Sec. 116.)	Under existing Federal law, the territory of the Virgin Islands is not part of the Federal-State unemployment insurance system. The territory does have its own U.C. program and participates in the SUA program.

Item	H.R. 10210—Subcommittee bill	Current law
9. Effective dates and transition provisions for extending U.C. coverage.	Makes provisions extending coverage to farm, domestic, and State and local government employees effective January 1, 1977. If a State agrees to pay benefits to qualified, newly covered workers as of January 1, 1977, based on wages earned prior to that date, benefits paid through June 30, 1977, and after if based on newly covered wages earned prior to January 1, 1977, would be reimbursed from general Federal revenues. (Sec. 121.)	SUA covers those workers not covered by the permanent Federal-State U.C. program. SUA expires December 31, 1976. (Public Law 93-567; Public Law 94-45 Sec. 201.)
10. Transition provisions for nonprofit employers.	Permits newly covered nonprofit employers who had already covered their employees and financed the benefit costs by the contribution method to transfer any accumulated balance to their accounts if they choose to switch to the reimbursement method of financing after enactment of this bill. (Sec. 122.)	A similar transition provision was enacted in the 1970 Unemployment Compensation Amendments. (IRC Sec. 3303(f).)

TITLE II—FINANCING PROVISIONS

11. Increase the unemployment insurance taxable wage base.	Increases the taxable wage base from $4,200 to $8,000 as of January 1, 1977. (Sec. 211.)	The FUTA tax base is the first $4,200 in wages paid to an employee in a calendar year. (IRC Sec. 3306(b)(1).
12. Increase the net Federal unemployment insurance tax rate and the proportion of FUTA revenues allocated to the Federal extended U.C. account.	Increases the net Federal tax rate from 0.5 percent to 0.7 percent as of January 1, 1976. Reduces it back to 0.5 percent in 1982 or the year after all advances to the Federal extended unemployment compensation account have been repaid, whichever occurs first. The proportion of FUTU revenues allocated to the Federal extended U.C. account is increased from 1/10 to 5/14 as long as the net Federal tax rate is 0.7 percent. (Sec. 211.)	The present net Federal tax rate is 0.5 percent. The proportion of revenues allocated to the Federal extended U.C. account is 1/10. (IRC Sec. 3301; SSA Title IX Sec. 905(b)(1).)
13. Change in financing administration and extended benefit costs attributable to State and local government employees.	Provides that in determining the Federal grants for administrative expenses reimbursement would not be allowed from FUTA revenues for administrative costs attributable to State and local government employees. (Sec. 212.) Revises the definition of "sharable benefits" under the Federal-State extended benefits program to eliminate any Federal sharing of extended benefits based upon services performed by workers in State and local governments. (Sec. 212.)	States receive annual Federal grants to cover their U.C. administrative expenses. The cost of benefits paid under the Federal extended benefits program (benefit weeks 27-39) is shared 50 percent from State UC funds and 50 percent from Federal UC funds. Both the Federal U.C. administrative grants to the States and the Federal share of extended benefits come from revenues raised by the Federal unemployment tax on employers (currently 0.5 percent on the first $4,200 of wages). State and local governments are not subject to this tax. (SSA Title III Sec. 302); IRC Sec. 3304(a)(11); P.L. 91-373 Sec. 204.)

[7] II. COMPARISON OF PROVISIONS WITH PRESENT LAW—Continued

TITLE I—EXTENSION OF COVERAGE PROVISIONS—Continued

Item	H.R. 10210—Subcommittee bill	Current law
14. Change in procedure for Federal unemployment insurance advances to States.	Allows States to request loans from the Federal unemployment trust funds to pay benefits for a 3-month period rather than a 1-month period. (Sec. 213.)	Under present Federal law a State must apply for Federal U.C. loans on a month-by-month basis. (SSA Title XII, Sec. 1201(a)(1)(A).)
15. Change in allocation of costs for U.C. benefits paid to Federal civilian employees and exservicemen.	Provides that, when an individual's U.C. benefits are based on both Federal and non-Federal employment, the Federal share of the cost would be based on the ratio of Federal wages to total base period wages. (Sec. 214.)	The Federal Government currently reimburses the State for "added cost" when an individual's U.S. payments are based in part on Federal employment. (Title 5 U.S.C. Sec. 8505(a).)
16. Reimbursement for U.C. benefits paid to CETA public service employees.	Provides for the States to be reimbursed from Federal general revenues for U.C. benefits paid to CETA public service employees. (Sec. 215.)	Where State covers State and local government employees CETA public service employees must receive same U.C. rights. Their benefit costs are financed from CETA grants, or if costs occur after expiration of CETA contract, from Department of Labor national office accounts. In other States, CETA public service employees are covered under the temporary special unemployment assistance program.

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[17] V. INFORMATION ON PRESENT PERMANENT AND TEMPORARY UNEMPLOYMENT COMPENSATION PROGRAMS

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[20] FINANCING THE PROGRAM

Under the provisions of the Internal Revenue Code, a tax is levied on covered employers at a current rate of 3.2 percent on wages up to $4,200 a year paid to an employee. The law, however, provides a credit against Federal tax liability of 2.7 percent to employers who pay State taxes under an approved State unemployment compensation program. This credit is allowed regardless of the tax paid to the State by the employer. Because all of the States now have an approved unemployment compensation program, the effective Federal tax is 0.5 percent. This Federal tax is used to pay all of the administrative costs, both State and Federal, associated with the unemployment compensation programs, to provide 50 percent of the benefits paid under the extended unemployment compensation program (P.L. 91-373), to pay the costs of benefits under the Emergency Unemployment Compensation Act of 1974 (as amended), and to maintain a loan fund from which an individual State may borrow (Title XII of the Social Security Act) whenever it lacks funds to pay the unemployment compensation benefits due for a month. In order to assure that a State will repay any loans it secures from the fund, the law provides that when a State has an outstanding loan balance on January 1 for two consecutive years, the full amount of the loan must be repaid by November 10 of the second year or the Federal tax on employers in that State will be increased under a somewhat complicated formula for that year and further increased for each subsequent year that the loan has not been repaid. Under a provision of P.L. 94-45 a three-year (1975, 1976, and 1977) suspension of the increases in tax rates is permitted for a State which the Secretary finds has taken appropriate steps to restore the fiscal soundness of its program and to provide for repayment of outstanding loans within a reasonable period of time.

All States levy taxes on employers within the State. Three States also collect contributions from employees. These taxes are deposited by the State to its account in an unemployment trust fund in the Federal Treasury, and withdraw as needed to pay benefits. *On December 31, 1974,* the total reserve of all States was $10.6 billion.

Standards rates

The standard rate of contribution under all but eight State laws is 2.7 percent. In New Jersey, the standard rate is 2.8 percent; Hawaii, Ohio, and Nevada, 3.0; and Montana, 3.1. In Nevada the 3.0 percent rate applies only to unrated employers. In Idaho the standard rate is 2.1 percent if the ratio of the unemployment fund to the total payroll for the fiscal year is 4.75 percent or more; when the ratio falls below [21] this point, the standard rate varies between 2.3 and 3.3 percent. Kansas has no standard contribution rate, although employers not eligible for an experience rate, and not considered as newly covered, pay at the maximum rate.

All State laws, except Puerto Rico, provide for a system of experience rating by which individual employers' contribution rates are varied from the standard rate on the basis of their experience with the amount of unemployment encountered by their employees.

Federal requirements for experience rating

The Federal law initially allowed

employers additional credit for a lowered rate of contribution if the rates were based on not less than 3 years of "experience with respect to unemployment or other factors bearing a direct relation to unemployment risk." In 1954 the 3-year requirement was relaxed and States were permitted to assign a reduced rate, based on their "experience," to new and newly covered employers who had at least one year of experience immediately preceding the computation date. Since 1970, States may also grant reduced rates (but not less than one percent) for newly covered employers.

State requirements for experience rating

In most States 3 years of experience with unemployment means more than 3 years of coverage and contribution experience. Factors affecting the time required to become a "qualified" employer include (1) the coverage provisions of the State law ("at any time" vs. 20 weeks); (2) in States using benefits or benefit derivatives in the experience-rating formula, the type of base period and benefit year and the lag between these two periods, which determine how soon a new employer may be charged for benefits; (3) the type of formula used for rate determinations; (4) the length of the period between the date as of which rate computations are made and the effective date for rates.

Taxable wage base

About one-third of the States have adopted a higher tax base than that provided in the Federal Unemployment Tax Act. In all States an employer pays a tax on wages paid to (or earned by) each worker within a calendar year up to the amount specified in State law. In addition, most of the States provide an automatic adjustment of the wage base if the Federal law is amended to apply to a higher wage base than that specified under State law. Beginning in 1975, Puerto Rico's tax base is 100 percent of total wages.

As a result of the many variables in State taxable wage base and tax rates benefit formulas and economic conditions, actual tax rates vary greatly among the States. In 1974 the average tax rate for all the States was 2.0% of taxable wages, ranging from a high of 3.7% in Massachusetts to a low of 0.3% in Colorado, both on a taxable wage base of $4,200. Tax rates as a percentage of total wages ranged from a high of 2.19% in Puerto Rico to 0.2% in Colorado, Texas, and Virginia. The national average tax rate, as a percentage of total wages was 1.0%.

Coverage

The Federal Unemployment Tax Act applies to employers who employ one or more employees in covered employment in at least [22] 20 weeks in the current or preceding calendar year or who pay wages of $1,500 or more during any calendar quarter of the current or preceding calendar year. State legislatures tend to cover employers or employment subject to the Federal tax because, while there is no compulsion to do so, failure to do so is of no advantage to the State and a disadvantage to the employers involved.

States frequently cover employees or employment which is exempt from the Federal tax but exempt employers and employment are subject to the Federal tax in only a few instances.

Although State adoption of unemployment insurance laws has therefore been greatly influenced by the Federal statute, with a single exception, the State is free to determine the employers who are liable for contributions and the workers who accrue rights under the laws. The sole exception is the Federal requirement that States provide coverage for employees of nonprofit organizations and of State hospitals and institutions of higher learning even though such employment is exempt from FUTA. Coverage is generally defined in terms of (a) the size of the employing unit's payroll or the number of days or weeks worked during a calendar year, (b) the employment relationship between the workers and the employer, and (c) the place where the worker is employed. Coverage under the laws is limited by exclusion of certain types of employment. In most States, however, coverage can be extended to exclude workers under provisions which permit voluntary election of coverage by employers.

Originally, most State laws covered only those employers who, within a year, had eight or more workers in each of 20 weeks. This was due largely to the coverage provisions of the FUTA. As the States gained experience in administering unemployment insurance and as a result of the 1954 and 1970 amendments to the FUTA smaller firms have been brought under the law in all States.

Thirty-one States have adopted the Federal definition of employer; i.e., a quarterly payroll of $1,500 in the calendar year or preceding calendar year or one worker in 20 weeks. Eight States provide the broadest possible coverage by including all employers who have any covered service in their employ. The other States have requirements of less than 20 weeks or payrolls other than $1,500 in a calendar quarter.

Exclusion from coverage

The following types of employment are generally exempt from coverage under FUTA, although certain States have provided coverage for some of the excluded services.

(*1*) *Agricultural labor.*—State laws generally exclude agricultural labor from coverage, except in five States.

(*2*) *Domestic service.*—Four States cover personal or domestic service in private homes, college clubs, or fraternities. The remaining States exclude domestic service in private homes and most of them exclude college clubs, fraternities, and sororities.

(*3*) *Service for relatives.* — All States exclude service for an employer by his spouse or minor child and, except in New York, service of an individual in the employ of his son or daughter.

(4) *Exempt nonprofit organizations, State hospitals and institutions of higher education.*—Although the 1970 amendments provided [23] coverage of certain services performed for nonprofit organizations and for State hospitals and institutions of higher education, the amendments permit the State to exclude certain services from State coverage. Services performed for a church, convention or association of churches, or an organization operated primarily for religious purposes may be exempt. Also the State may exempt services performed by a duly ordained, commissioned, or licensed minister or a member of a religious order; in the employ of a school which is not an institution of higher education; by the beneficiaries of the program in a facility conducting a program of rehabilitation for persons whose earning capacity is impaired or in a government sponsored work-relief or work-training program; or by inmates of correctional institutions employed in a hospital connected with the institution.

(5) *Service of students and spouses of students.*—Prior to the 1970 amendments, service in the employ of a school, college or university by a student enrolled and regularly attending classes at such school was excluded from FUTA definition of employment. The 1970 amendments retained this exclusion and also excluded service performed after December 31, 1969 by a student's spouse for the school, college or university at which the student is enrolled and regularly attending classes, provided the spouse's employment is under a program designed to give financial assistance to the student, and the spouse is advised that the employment is under such student-assistance program and is not covered by any program for unemployment insurance. Also excluded after December 31, 1969, is service performed for an employer other than a school, college, or university by a full-time student under the age of 22 in a work-study program provided that the service is an integral part of an educational program.

(6) *Service of patients for hospitals.*—The 1970 amendments excluded from the FUTA definition of employment service performed for a hospital after December 31, 1969, by patients of the hospital. Such service may be excluded from coverage under the State law whether it is performed for a hospital which is operated for a profit or for a nonprofit or State hospital which must be covered under the State law.

(7) *Service for Federal instrumentalities.* — An amendment to the FUTA, effective with respect to services performed after 1961, permits States to cover Federal instrumentalities which are neither wholly nor partially owned by the United States, not exempt from the tax imposed under section 3301 of the Internal Revenue Code by virtue of any other provision of law which specifically refers to such section of the Code in granting such exemptions. All States except New Jersey have provisions in their laws that permit the coverage of service performed for such wholly privately owned Federal instrumentalities.

(8) *Service for State and local governments.*—Although the Federal act requires that certain service for State hospitals and State institutions of higher education be covered under the State law, it continues to exclude from coverage under the act service performed for State and local governments or their instrumentalities.

All States cover at least those categories of workers required to be covered under the Federal law and most States provide some form of [24] coverage for other State and local government workers. About one-half of the States provide mandatory coverage for all State employees, and permit election of coverage by municipal corporations or other local government subdivisions. Several States, in addition to covering their own government workers, also provide mandatory coverage for special groups of workers employed by their instrumentalities or political subdivisions.

(9) *Maritime workers.* — The FUTA and most State laws initially excluded maritime workers, principally because it was thought that the Constitution prevented the States from covering such workers. Supreme Court decisions in *Standard Dredging Corporation* v. *Murphy* and *International Elevator Company* v. *Murphy,* 319 U.S. 306 (1943), were interpreted to the effect that there is no such bar. In 1946 the FUTA was amended to permit any State from which the operations of an American vessel operating on navigable waters within and without the United States are ordinarily regularly supervised, managed, directed, and controlled, to require contributions to its unemployment fund under its State unemployment compensation law. Most States now have such coverage.

(10) *Coverage of service by reason of Federal coverage.*—Most States have a provision that any service covered by the FUTA is employment under the State law. This provision would permit immediate coverage of excluded workers if the Federal act were amended to include them. Many States have added another provision that automatically covers any service which the Federal law requires to be covered.

(11) *Voluntary coverage of excluded employments.*—In all States except Alabama, Massachusetts, and New York, employers, with the approval of the State agency, may elect to cover most types of employment which are exempt under their laws. The Massachusetts law, however, does permit services for nonprofit organizations to be covered on an elective basis and the New York law permits employers to elect coverage of agricultural workers under certain conditions.

(12) *Self-employment.* — Employment, for purposes of unemployment insurance coverage, is employment of workers who work for others for wages; it does not include self-employment. One small exception has been incorporated in the California law. A subject employer who is not in seasonal industry may apply for cov-

erage for his own services: if his election is approved, his wages for purposes of contributions and benefits are deemed to be $2,748 a quarter, and his contribution rate is fixed at 1.25 percent of wages.

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[38] VI. SECTION BY SECTION EXPLANATION AND JUSTIFICATION

TITLE I—EXTENSION OF COVERAGE PROVISIONS

PART I—GENERAL PROVISIONS

Sec. 111. Coverage of Certain Agricultural Employment

This section amends the definition of employment subject to the Federal unemployment tax to include agricultural labor performed for farm employers who, during the current or preceding calendar year, employed four or more workers in each of 20 weeks, or paid $5,000 or more in wages in a calendar quarter. The section excludes from coverage aliens admitted to the United States to perform agricultural labor under contract to an employer and who return to their own country upon completion of the contract. These provisions become effective with respect to services performed after December 31, 1976. The alien exclusion continues in effect through December 31, 1978.

This section extends U.C. protection to a substantial majority of hired farm workers (over three-fifths, or about 710,000 jobs), even though it makes only 7 percent of farm employers (69,000) subject to the Federal unemployment tax. Extending coverage at this time to the larger agricultural enterprises will provide protection for most of the nation's farm workers and allow State agencies and the Federal Government to gain experience necessary for the consideration of extending coverage to workers on smaller farms.

Farm work was excluded from the definition of employment in the original Federal Unemployment Insurance law in 1935 on the ground that it was not administratively feasible to apply the Federal tax to farm employment. The experience of States that have covered farm workers and the extension of income and Social Security taxes to agricultural enterprises have demonstrated the administrative feasibility of extending U.C. coverage to farm workers.

Many businesses engaged in agriculture are already covered under the Federal Unemployment Tax Act and under State unemployment insurance laws because of their substantial nonfarm employment. For them, wages attributable to agricultural activities which are now segregated to take advantage of the present exclusion of such activities will no longer be segregated. These wages will be subject to the Federal tax and State contributions, agricultural workers will receive the same "credit" for their employment as other employees of the firm, and the unemployment experience of all employees (farm and non-farm) will be reflected in the firm's experience rating.

Studies sponsored by the Department of Labor indicate that providing unemployment compensation benefits to eligible farm workers who become involuntarily unemployed would have little or no impact on overall unemployment compensation cost rates in the 18 States surveyed. In two States—California and Florida—the inclusion of farm workers in the unemployment compensation program would produce a small increase in overall benefit cost rates of the program. California has recently amended its law to extend coverage to agricultural labor, making a total of three states (California, Minnesota and Hawaii plus Puerto Rico and Washington, D.C.) that presently cover farmworkers.

[39] The alien exclusion provided in this section affects approximately 10,000 to 13,000 individuals who are brought into the United States under sections 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act to work during peak agricultural crop seasons, primarily in Florida. Since they return to their country of origin upon completion of the contract, they are unlikely ever to qualify for or receive benefits. The alien exclusion, which relieves farm employers of the necessity of paying the Federal unemployment tax for these workers, is effective for two years. The time limitation will permit Congress to assess the impact of the exclusion in terms of whether employers are encouraged to hire aliens rather than U.S. citizens as a result of this provision.

Sec. 112. Treatment of Certain Farmworkers

This section provides that an individual furnished by a crew leader to perform agricultural labor for a farm operator will be considered the employee of the crew leader if the crew leader is registered under the Farm Labor Contractor Registration Act of 1963, or if the members of the crew operate mechanized equipment also furnished by the crew leader. The farm operator will be considered the employer if the crew leader is not so registered or does not furnish mechanized equipment as part of his service to the farm operator.

The purpose of this section is to protect the migrant farm workers whose services are furnished to farm operators by crew leaders. The 1974 amendments to the Farm Labor Contractor Registration Act require the farm operator to (1) make sure that the contractor is properly registered before using the contractor's services, and (2) obtain from the contractor payroll records (of which the contractor is required to keep a copy) pertaining to migrant workers recruited for the farm operator's benefit. Because crew leaders who furnish mechanized equipment are readily identifiable and generally firmly established, they will be considered employers for the purposes even if they are not registered under the Farm Labor Contractor Registration Act.

Making the crew leader the employer fixes the migratory worker's wage credits in a single State. The worker's wage credits could be scattered among several States, making

benefit rights more difficult to establish, if the farm operator, rather than the crew leader, were designated the employer.

The farm operator is the employer if the crew leader is not registered under the Farm Labor Contractor Registration Act or does not furnish mechanized equipment as part of the service to the farm operator. The farm operator is also the employer of workers furnished by a registered farm labor contractor when such workers are the employees of the farm operator under the common law test. For example, some farm operators employ individuals to recruit farm workers exclusively for them. Although these individuals may be required to register under the Farm Labor Contractor Registration Act, the farm workers are employed directly by the farm operator. The farm operator will be considered the employer in these cases.

Sec. 113. Coverage of Domestic Service

This section extends the Federal unemployment tax to wages paid for domestic service in a private home, local college club, or local [40] chapter of a college fraternity or sorority if the employer paid $600 or more for such service in any calendar quarter. This section is effective after December 31, 1976.

This section extends unemployment compensation protection to about 400,000 workers, or about 27 percent of all employment in domestic service. The domestic workers covered by this provision have demonstrated substantial labor force attachment in the States which now cover domestic service employment. They include chauffeurs, social secretaries, cooks, maintenance people and others who would be covered under present law if they worked in commercial or nonprofit establishments. New York and the District of Columbia currently provide coverage if the employer's quarterly payroll for domestic service is at least $500, Hawaii if the employer's quarterly payroll is at least $225, Arkansas if it is $500 or the employer has 3 or more domestic workers. The calendar quarterly payroll criterion was set at $600 in order to exclude the household which employs a single day worker each week.

Sec. 114. Definition of Employer

This section amends the definition of employer for FUTA purposes to conform with the definition of employment and wages pertaining to domestic and agricultural service added in Sections 111-113 of this bill. It defines employer for Federal unemployment tax purposes generally and with respect to agricultural labor and domestic service.

Under a special rule, any person who qualifies for U.C. tax purposes as an employer of domestic services (because he paid at least $600 in a quarter for such services) will not be considered as employer for other covered services on the basis of the combined wages paid for domestic and other services. In order to qualify for U.C. tax purposes as an employer of other non-agricultural services, an employer of domestic workers will have to meet the general test (employ at least one worker in each of 20 weeks or have a quarterly payroll of at least $1,500), without consideration of his domestic workers or wages paid for domestic services. In order to be considered an agricultural employer, he will have to qualify as a farm employer (employ four or more farm workers in each of 20 weeks or pay at least $5,000 in quarterly wages for farm services), independent of any domestic services and wages. However, an employer who qualifies as an agricultural employer also meets the general test for employers (at least one worker in each of 20 weeks or a quarterly payroll of at least $1,500) and will be taxed with respect to other services, except domestic services, in his employ. This employer will still have to pay at least $600 in a quarter for domestic services in order to be covered for such service.

There are two reasons for the special rule applying to the definition of an employer of domestic services: (1) To prevent an employer of domestic workers from qualifying as an employer under the general test until he pays at least $1,500 in quarterly wages for other services; and (2) to prevent a person who qualifies as an employer under the general test or the agricultural employer test from qualifying as an employer of domestic services until he pays at least $600 in a quarter for such services.

[41] *Sec. 115. Coverage of Certain Service Performed for Nonprofit Organizations and for State and Local Governments*

This section requires States, as a condition for tax offset credit to their employers, to extend coverage to employees of non-profit primary and secondary institutions of education, thus broadening present required coverage limited to non-profit institutions of higher education.

This section also requires States to extend coverage to all State and local government employment with certain specified exclusions. The exclusions apply to services performed by employees in the exercise of their duties as: elected officials; appointed officials whose terms are specified by law or who are not required to work on a full-time basis; members of legislative bodies or of the judiciary; members of the State National Guard or Air National Guard; employees hired for the duration of such emergencies as fire, storm, snow, earthquake, flood, or other similar emergencies; and inmates of custodial or penal institutions.

The purpose of this section is to provide unemployment compensation protection for approximately 600,000 jobs in State government and some 7.7 million jobs in local governments. States are now required to cover only State government employees of hospitals and institutions of higher education. At present, however, 29 States cover substantially all State government employees and 8 States cover most local government workers. States are also now required to permit local governments to elect coverage for their

employees in hospitals and institutions of higher education.

Under this section, the current limitations on the payment of benefits between school terms to certain categories of college and university employees is retained. These provisions prohibit the payment of benefits based on services performed for an institution of higher education in an instructional, research, or principal administrative capacity during the period between academic years or terms, if an individual has a contract to perform similar services for both such years or terms for any institution of higher education. This section extends these provisions to instructors, researchers and administrators in *all* educational institutions. Thus a teacher in a secondary school with a contract for both terms will be treated during periods between such terms the same as a college instructor.

This section also provides that, prior to January 1, 1979, States may deny benefits based on service performed in a capacity *other* than instructional, research, or administrative for an educational institution (other than an institution of higher education) during the period between two successive academic terms or similar periods, if the employee has reasonable assurance of being employed in such service during the later term.

The 2-year limitation on the States' option to provide for denial of benefits between school terms in the case of non-professional employees of primary, secondary and vocational educational institutions is consistent with current law in some States and will permit a reexamination of this provision by the Congress on the basis of State experience.

Under this bill the States are required to cover State and local government employees as a condition for receiving the 2.7 percent tax [42] credit and Federal grant for administering State unemployment insurance programs. The committee believes that there are no valid constitutional objections to this provision. Requiring such coverage as a condition for a tax credit is well within the Congressional power to lay and collect taxes for the General Welfare and does not infringe on State rights.

In *Steward Machine Co.* v. *Davis,* 301 U.S. 548 (1937), the Supreme Court held that Congress has the power to prescribe conditions for a tax credit under its authority to lay and collect taxes as long as the conditions are within the scope of national policy and are not arbitrary. Specifically, such prerequisites must be related in substance to the activity being taxed and a benefit must be provided in exchange for compliance with the condition. The condition in this bill, which requires the states to cover State and local government employees in exchange for a tax credit and a Federal grant, clearly meets this standard.

Steward Machine also answers the contention that the imposition of this condition for a tax credit infringes on State rights guaranteed by the Tenth Amendment. For, the Supreme Court, in considering just such an attack upon the federal unemployment law, concluded that state power includes the authority to make contracts and consent to the offer by the Federal government of a Federal tax credit and grant. Under this bill, a Federal tax is not levied on the state government. Instead, the State has the option of consenting to the condition if it wants to participate in the Federal-State Unemployment Compensation system. A State which agrees to cover its state and local government employees is merely exercising its power to agree to cooperate with the Federal government in exchange for certain benefits.

Sec. 116. Extension of Federal Unemployment Compensation Law to the Virgin Islands

This section permits the U.S. Virgin Islands to become part of the Federal-State employment security system.

Under existing Federal law, the territory of the Virgin Islands is not considered a "State" for purposes of participating in the Federal-State employment security system. However, the Virgin Islands has its own unemployment compensation program, and the territorial government, through its Legislature and Governor, has formally requested that the Virgin Islands be included in the Federal-State system.

If the Virgin Islands is incorporated in the Federal-State U.C. system as provided in this section, the cost of administering its unemployment compensation program, now paid by Virgin Islands employers as part of their territorial unemployment insurance tax, will be borne by grants from the employment security administration account in the Federal Unemployment Trust Fund under Title III of the Social Security Act. The Virgin Islands will participate (on a 50/50 cost-sharing basis) in the Extended Benefit program of the Federal-State Extended Unemployment Compensation Act of 1970 (Title II, Public Law 91-373) [1970-2 C.B. 348, 355]. And it will participate in the interstate, wage-combining arrangements which are mandatory under the Federal Unemployment Tax Act for members of the system.

The advantages to the United States of including the Virgin Islands in the system are the increased scope and coverage of the [43] Federal-State system, the increased effectiveness of its interstate and multi-state operations, and the elimination of a tax advantage for Virgin Islands employers. Costs of administering the Virgin Islands Employment Service are now borne by general funds of the U.S. Treasury but, upon inclusion of the Virgin Islands in the Federal-State system, most of these costs will be financed by grants from the employment security administration account in the Federal Unemployment Trust Fund.

Under present law (Public Law 94-45) [1975-2 C.B. 513], the Secretary of Labor is authorized to loan up to $5 million to the Virgin Islands to enable it to continue to pay benefits

under its unemployment compensation program. These loans are interest free until January 1, 1978. After that date, interest will be charged on any outstanding loan. If the Virgin Islands is incorporated in the Federal-State unemployment insurance system, any outstanding loans at that point will be treated as though the Virgin Islands had been in the system. This means that, if the time for repayment has elapsed and any part of the loan remains outstanding, the increased Federal unemployment tax rates provided for in existing law for the purpose of recapturing overdue loans would immediately go into effect.

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[45] TITLE II—FINANCING PROVISIONS

Sec. 211. Increase in Federal Unemployment Tax Wage Base and Rate

This section increases both the taxable wage base and the tax rate of the Federal unemployment tax. The taxable wage base (now $4,200) is increased to $8,000, effective with respect to remuneration paid after December 31, 1976.

The Federal unemployment tax rate, now 3.2 percent of taxable wages, is increased to 3.4 percent, effective for remuneration paid after December 31, 1975. The tax rate increase is a temporary measure that will expire beginning January 1, 1982, or January 1 of the first calendar year following 1975 in which there are no outstanding repayable advances to the Extended Unemployment Compensation Account in the Federal unemployment trust fund, whichever of these occurs first.

Increasing the Federal tax rate from 3.2 percent to 3.4 percent raises the net Federal tax (3.4 minus the 2.7 percent credit to employers subject to approved State unemployment compensation laws) from 0.5 percent to 0.7 percent. The 0.2 percent increase is used to raise the proportion of Federal unemployment tax revenue earmarked for the Extended Unemployment Compensation Account from one-tenth under present law (the equivalent of 0.05 percent) to five-fourteenths (the equivalent of 0.25 percent).

The U.C. program is no longer self-supporting, and the financial structure of the system at both the State and Federal levels is seriously threatened:

Fifteen States have depleted their U.C. funds and 25 to 30 will be forced to borrow from the Federal government by the end of calendar year 1976. As of December 15, 1975, the 15 States with depleted funds had borrowed $1.4 billion from the Federal loan fund. The Department of Labor estimates that, under present financing provisions, the State U.C. trust funds will have deficits [46] amounting to $16.5 billion in 1978, $19.3 billion in 1982 and $24.1 billion in 1984.

The Federal Unemployment Account (from which the States with depleted trust funds borrow money) and the Extended Unemployment Compensation Account (which finances the Federal share of the Extended Benefits program) are both depleted and borrowing Federal general revenues. The Department of Labor projects that, under the existing tax base and net Federal tax rate, the Federal U.C. trust funds will have a deficit of $6.2 billion in 1978, increasing to $8.2 billion in 1982 and $9.6 billion in 1984.

According to DOL estimates, unless changes are made in existing financing provisions, the Federal and State U.C. trust funds will have combined deficits of $22.7 billion in 1978, increasing to $27.5 billion in 1982 and $33.7 billion in 1984.

These deficits are the result of unprecedent costs during the recent period of high unemployment and the failure of Congress and the States to maintain adequate financing. Originally there was no limitation on the amount of individual wages subject to the U.C. tax. A $3,000 limitation was adopted in 1939 primarily because of the $3,000 limitation in the old-age and survivors insurance program. Using the same wage base was supposed to facilitate reporting under both programs. Increases in the Federal U.C. tax base (now $4,200) have not kept pace with increases in the Social Security tax base (now $14,100). Currently, only 49.6 percent of total wages are subject to the Federal U.C. tax, and it is estimated that the proportion would decline to less than 40 percent by 1981 under the current wage base of $4,200. The $8,000 taxable wage base contained in this bill represents 61.5 percent of total wages in 1977 and would still be above 50 percent in 1981.

The increase in the taxable wage base to $8,000 will be effective as of January 1, 1977. This will allow States enough time to increase the State U.C. tax base to $8,000 and thereby assure employers a full offset credit against the $8,000 Federal (FUTA) base. (Thirty-nine States provide for an automatic increase in the State U.C. wage base when the Federal wage base is increased.) The increase in the Federal tax rate, which does not require subsequent State legislative action, will be effective at the earliest possible date, January 1, 1976. The Department of Labor estimates that these changes will raise an additional $6.3 billion ($1.6 billion in Federal revenues and $4.7 billion in State revenues) in fiscal 1978. According to DOL projections, these additional revenues will produce a positive balance in the Federal U.C. trust funds and a positive "average balance" in the States' U.C. trust funds in 1981.

The financing amendments in this bill seek to restore fiscal soundness at the State and Federal level as soon as possible and to distribute fairly the impact of the tax on all employers. Further steps may be needed in the future. A study of the long-range needs and viable solutions will be one of the major tasks of the proposed National Commission.

[47] *Sec. 212. Financing Coverage of State and Local Government Employees*

This section requires that, effective

January 1, 1978, Federal grants to States for the administrative costs of unemployment compensation and employment services will no longer include costs attributable to State and local government employees. Effective at the same time, the Federal share of benefits paid under the Extended Benefits Program (benefit weeks 27 to 39) will no longer include the costs of extended benefits paid to State and local government employees.

Federal administrative grants to the States and the Federal share of benefits paid under the Extended Benefit Program are financed out of revenues raised by the Federal U.C. tax, presently 0.5 percent of the first $4,200 of wages. State and local governments, including those that currently provide unemployment compensation protection for their employees, do not pay this tax and will not be required to do so under this bill. Therefore, Federal administrative grants and the Federal share of extended benefits attributable to their employees will not be financed out of the Federal U.C. tax revenues. States, or State and local governments, will have to absorb these costs.

* * * * *

[53] VII. SECTION-BY-SECTION ANALYSIS

Section 1 contains the short title of the bill—"The Unemployment Compensation Amendments of 1975". The remainder of the bill is divided into four titles as follows:

TITLE I—EXTENSION OF COVERAGE PROVISIONS

TITLE II—FINANCING PROVISIONS

TITLE III—BENEFIT PROVISIONS

TITLE IV—NATIONAL COMMISSION ON UNEMPLOYMENT COMPENSATION

TITLE I—EXTENSION OF COVERAGE PROVISIONS

PART I—GENERAL PREVISIONS

Sec. 111. Coverage of Certain Agricultural Employment

Section 111(a) amends section 3306 (b) of the Internal Revenue Code of 1954 to provide that only cash remuneration paid for agricultural labor will be treated as wages for purposes of the Federal unemployment tax. As a result, the Federal unemployment tax will not be imposed with respect to non-cash remuneration paid for agricultural labor.

Section 111(b) amends section 3306 (b) of the Internal Revenue Code of 1954 to provide that agricultural labor performed for certain employers will be treated as employment for purposes of the Federal unemployment tax. Under the amendment, agricultural labor will be treated as employment if such labor is performed for an employer who, during any calendar quarter in the calendar year of the preceding calendar year, paid cash remuneration of $5,000 or more for individuals [54] employed in agricultural labor or who on each of some twenty days during the calendar year or the preceding calendar year employed at least four individuals in agricultural labor. The amendment also provides that agricultural labor performed before January 1, 1979, by aliens who are admitted to the United States pursuant to sections 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act will not be treated as employment for purposes of the Federal unemployment tax. The Federal unemployment tax will be imposed on wages paid for agricultural labor which is treated as employment.

The amendments made by section 111 apply with respect to remuneration paid after December 31, 1976, for services performed after such date.

Sec. 112. Treatment of Certain Farmworkers

Section 112 amends section 3306 of the Internal Revenue Code of 1954 by adding to such section a new subsection (o) which contains special rules for determining who will be treated as the employer, and therefore liable for the Federal unemployment tax, in the case of agricultural workers who are members of a crew furnished by a crew leader to perform agricultural labor for a farm operator.

Under paragraph (1) of the new subsection (o), individuals who are members of a crew furnished by a crew leader to perform agricultural labor for a farm operator will be treated as employees of the crew leader if the crew leader is registered under the Farm Labor Contractor Registration Act of 1963 or if substantially all the members of such crew operate or maintain mechanized equipment furnished by the crew leader. A member of a crew furnished by a crew leader to perform agricultural labor for a farm operator will not, under such paragraph (1), be treated as an employee of the crew leader if under the common law definition of employee such individual would be treated as an employee of the farm operator.

Under paragraph (2) of the new subsection (o), any individual who is furnished by a crew leader to perform agricultural labor for a farm operator and who is not treated as an employee of the crew leader under paragraph (1) of such subsection will be treated as an employee of the farm operator. In such a case, the farm operator will be treated as having paid wages to such individual in an amount equal to the amount of wages paid to such individual by the crew leader.

Paragraph (3) of the new subsection (o) defines crew leader to mean any individual who furnishes individuals to perform farm agricultural labor for any other person, who pays the individuals so furnished by him for such agricultural labor, and who has not entered into a written agreement with such other person under which he is designated as an employee of such other person.

The amendment made by section 12 applies with respect to remuneration paid after December 31, 1976, for services performed after such date.

Sec. 113. Coverage of Domestic Service

Section 113 amends section 3306 (c) of the Internal Revenue Code of 1954 so as to treat domestic service in a private home, local college club, or local chapter of a college fraternity or sorority as employment if such domestic service is performed for an employer who paid cash [55] remuneration of $600 or more for such domestic service in any calendar quarter in the calendar year or the preceding calendar year. As a result, the Federal unemployment tax will be imposed on wages paid for such domestic service.

The amendment made by section 113 applies with respect to remuneration paid after December 31, 1976, for services performed after such date.

Sec. 114. Definition of Employer

Section 114(a) amends section 3306 (a) of the Internal Revenue Code which defines employer for purposes of the Federal unemployment tax.

The amendment makes it clear that any person who, during any calendar quarter in the calendar year or the preceding calendar year, paid wages of $5,000 or more for agricultural labor or who, during the calendar year or the preceding calendar year, employed at least four individuals in agricultural labor will be treated as an employer. Such a person shall also be treated as an employer with respect to services other than agricultural labor.

Under the amendment, a person who pays more than $600 in wages to individuals performing domestic service in a private home, local college club, or local chapter of a college fraternity or sorority will be treated as an employer. Any person treated as an employer with respect to such domestic service will not be treated as an employer with respect to any other type of service unless such person is defined as an employer with respect to such other services.

Section 114(b) makes a technical amendment to section 6157(a) of the Internal Revenue Code of 1954 which requires the payment of unemployment taxes on a quarterly or other time period basis. The amendment is required because under the amendment made by section 114(a) a person may be treated as an employer with respect to some services but not with respect to others. As a result a technical amendment is needed to section 6157(a) which, in its present form, reflects the fact that under existing law, if a person is an employer, he will be treated as an employer with respect to all services subject to the Federal unemployment tax.

The amendments made by section 114 applies with respect to remuneration paid after December 31, 1976, for services performed after such date.

Sec. 115. Coverage of Certain Services Performed for Nonprofit Organizations and for State and Local Governments

Section 115(a) amends section 3309 (a)(1)(B) of the Internal Revenue Code of 1954 so as to require each State to pay unemployment compensation on the basis of employment by State and local governments as a condition for approval of the State unemployment compensation law by the Secretary of Labor under section 3304(a) of the Internal Revenue Code of 1954.

Section 115(b) amends section 3309 (b) of the Internal Revenue Code of 1954 to provide that the State is not required to provide unemployment coverage of certain State or local government employees. The State is not required to cover any individual employed by a State or local government if such individual is (1) an elected official or an [56] appointed official if such appointed official serves for a specific term established by law or is not required to perform services on a substantially full-time basis; (2) a member of a legislative body, or a member of the judiciary, of a State or local government; (3) a member of the State national guard or air national guard; or (4) a temporary employee serving as a result of a fire, storm, snow, earthquake, flood, or other similar emergency, or (5) an inmate of a custodial or penal institution.

Section 115(b) also has the effect of requiring the State to pay unemployment compensation on the basis of services performed for all educational institutions. Under existing law, the State is only required to provide coverage of services performed for institutions of higher education.

Section 115(c) amends sections 3304(a)(6)(A) of the Internal Revenue Code of 1954 to provide that the existing rules dealing with the denial of unemployment compensation to teachers and other professional employees of institutions of higher education during periods between academic years or similar terms will also apply to the newly covered teachers and other professional employees of other educational institutions. However, the amendments made by section 115(c) provide for new rules for the treatment of nonprofessional employees of educational institutions which are not institutions of higher education. Under such new rules, the State may deny compensation to such nonprofessional employees for any week which begins before January 1, 1979, and which commences during a period between two successive academic terms or similar periods if the employee performed services in the first of such academic terms or similar periods and there is a reasonable assurance that such employee will perform such service the second of such academic terms or similar periods.

The amendments made by section 115 shall apply to certifications of States for 1977 and subsequent years, but only with respect to services performed after December 31, 1976.

Sec. 116. Extension of Federal Unemployment Compensation Law to the Virgin Islands

Section 116(a) amends section 1101 (a) of the Social Security Act to treat the Virgin Islands as a State for purposes of those provisions of the Social Security Act which deal with unemployment compensation.

Section 116(b) amends the Internal Revenue Code of 1954 to treat the Virgin Islands as a State for purposes of the Federal unemployment tax. As a result of this amendment, employers in the Virgin Islands will be liable for the Federal unemployment tax.

Subsections (c), (d), and (e) of section 116 contain technical amendments to other Federal laws which are necessary to extend Federal unemployment compensation laws to the Virgin Islands.

In general, the amendments made by section 116 take effect on the day after the day on which the Secretary of Labor approves under section 3304 (a) of the Internal Revenue Code of 1954 an unemployment compensation law submitted to him by the Virgin Islands for approval. The amendments made by section 116 to the Internal Revenue Code of 1954 apply to remuneration paid after December 31 of the year in which the Secretary of Labor approves such law, for services performed after such December 31. The Secretary of Labor may [57] not approve any unemployment compensation law submitted to him by the Virgin Islands until the governor of the Virgin Islands has approved the transfer to the Federal unemployment trust fund established by section 904 of the Social Security Act any amount in the unemployment sub-fund of the Virgin Islands established under section 310 of title 24 of the Virgin Islands Code.

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[58] TITLE II—FINANCING PROVISIONS

Sec. 211. Increase in Federal Unemployment Tax Wage Base and Rate

Section 211(a) amends section 3306 (b)(1) of the Internal Revenue Code of 1954 so as to increase the amount of wages subject to the Federal unemployment tax from $4,200 to $8,000. The amendment

* * * * *

[59] made by this section applies to remuneration paid after December 31, 1976.

Section 211(b) amends section 3301 of the Internal Revenue Code of 1954 which establishes the rate of the Federal unemployment tax. Under the amendment, the rate of such tax would be temporarily increased from 3.2 percent to 3.4 percent. Such increased rate would apply for each calendar year which begins before the earlier of—

(1) calendar year 1982, or

(2) the first calendar year after 1975 as of January 1 of which there is not a balance of repayable advances made to the extended unemployment compensation account established by section 905(a) of the Social Security Act.

In the case of the earlier of the calendar years referred to in paragraphs (1) and (2) and each calendar year thereafter, the rate would drop back to 3.2 percent. The amendment made by this section applies to remuneration paid after December 31, 1975.

Section 211(c) contains technical amendments to the Social Security Act. Under the amendments, the entire amount of the increase in Federal unemployment tax receipts resulting from the increase in the tax rate would be transferred into the extended unemployment compensation account. Section 211(c) also contains an amendment to a provision of the Internal Revenue Code of 1954 which requires quarterly payment of the unemployment tax.

Sec. 212. Financing Coverage of State and Local Government Employees

Section 212(a) amends section 302 (a) of the Social Security Act to provide that payments made to States for the proper and efficient administration of their unemployment compensation laws will not include amounts attributable to the administration of such laws with respect to services performed by employees of State and local governments. The amendment made by this section applies to amounts certified under section 302(a) of the Social Security Act for calendar quarters beginning on or after January 1, 1978.

Section 212(b) amends section 204 (a) of the Federal-State Extended Unemployment Compensation Act of 1970 so as to reduce the amount payable under such Act in respect of any compensation to the extent that such compensation is payable on the basis of services performed for a State or local government. This amendment applies with respect to compensation for weeks of unemployment beginning on or after January 1, 1978.

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Conference Report No. 94-1745 2d Session

[Bracketed numerals indicate official report page numbers.]

THE UNEMPLOYMENT COMPENSATION AMENDMENTS OF 1976

October 1, 1976

Mr. ULLMAN, from the committee of conference, submitted the following conference report to accompany H.R. 10210.[1]

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 10210) to require States to extend unemployment compensation coverage to certain previously uncovered workers; to increase the amount of the wages subject to the Federal unemployment tax; to increase the rate of such tax; and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the House recede from its disagreement to the amendments of the Senate numbered 3, 11, 12, 14, 17, 18, 19, 21, 29, 30, 33, 36, 37, 38, 39, 40, 41, 43, 44, 45, and 46, and agree to the same.

That the Senate recede from its amendments numbered 2, 5, 6, 7, 8, 9,

[1] Public Law 94-566, page 564.

10, 13, 16, 20, 22, 26, 27, 28, 34, 35, and 52.

Amendment numbered 1:

That the House recede from its disagreement to the amendment of the Senate numbered 1 and agree to the same with an amendment as follows:

Strike out the matter proposed to be stricken out by the Senate amendment, and on page 2 of the House bill after line 3 insert the following:

SEC. 111. COVERAGE OF CERTAIN AGRICULTURAL EMPLOYMENT.

(a) NONCASH REMUNERATION.—*Section 3306(b) of the Internal Revenue Code of 1954 (defining wages) is amended by striking out "or" at the end of paragraph (9), by striking out the period at the end of paragraph (10) and inserting in lieu thereof "; or", and by adding at the end thereof the following new paragraph:*

"(11) remuneration for agricultural labor paid in any medium other than cash.".

[2] *(b)* COVERAGE OF AGRICULTURAL LABOR.—*Paragraph (1) of section 3306(c) of such Code (defining employment) is amended to read as follows:*

"(1) agricultural labor (as defined in subsection (k)) unless—

"(A) such labor is performed for a person who—

"(i) during any calendar quarter in the calendar year or the preceding calendar year paid remuneration in cash of $20,000 or more to individuals employed in agricultural labor (not taking into account labor performed before January 1, 1980, by an alien referred to in subparagraph (B)), or

"(ii) on each of some 20 days during the calendar year or the preceding calendar year, each day being in a different calendar week, employed in agricultural labor (not taking into account labor performed before January 1, 1980, by an alien referred to in subparagraph (B)) for some portion of the day (whether or not at the same moment of time) 10 or more individuals; and

"(B) such labor is not agricultural labor performed before January 1, 1980, by an individual who is an alien admitted to the United States to perform agricultural labor pursuant to sections 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act;".

(c) EFFECTIVE DATE.—*The amendments made by this section shall apply with respect to remuneration paid after December 31, 1977, for services performed after such date.*

SEC. 112. TREATMENT OF CERTAIN FARMWORKERS.

(a) GENERAL RULE.—*Section 3306 of the Internal Revenue Code of 1954 (relating to definitions) is amended by adding at the end thereof the following new subsection:*

"(o) SPECIAL RULE IN CASE OF CERTAIN AGRICULTURAL WORKERS.—

"(1) CREW LEADERS WHO ARE REGISTERED OR PROVIDE SPECIALIZED AGRICULTURAL LABOR.—*For purposes of this chapter, any individual who is a member of a crew furnished by a crew leader to perform agricultural labor for any other person shall be treated as an employee of such crew leader—*

"(A) if—

"(i) such crew leader holds a valid certificate of registration under the Farm Labor Contractor Registration Act of 1963; or

"(ii) substantially all the members of such crew operate or maintain tractors, mechanized harvesting or crop-dusting equipment, or any other mechanized equipment, which is provided by such crew leader; and

"(B) if such individual is not an employee of such other person within the meaning of subsection (i).

"(2) OTHER CREW LEADERS.—*For purposes of this chapter, in the case of any individual who is furnished by a crew leader to perform agricultural labor for any other person and who is not treated as an employee of such crew leader under paragraph (1)—*

"(A) such other person and not the crew leader shall be treated as the employer of such individual; and

[3] *"(B) such other person shall be treated as having paid cash remuneration to such individual in an amount equal to the amount of cash remuneration paid to such individual by the crew leader (either on his behalf or on behalf of such other person) for the agricultural labor performed for such other person.*

"(3) CREW LEADER.—*For purposes of this subsection, the term 'crew leader' means an individual who—*

"(A) furnishes individuals to perform agricultural labor for any other person,

"(B) pays (either on his behalf or on behalf of such other person) the individuals so furnished by him for the agricultural labor performed by them, and

"(C) has not entered into written agreement with such other person under which such individual is designated as an employee of such other person."

(b) EFFECTIVE DATE.—*The amendment made by subsection (a) shall apply with respect to remuneration paid after December 31, 1977, for services performed after such date.*

SEC. 113. COVERAGE OF DOMESTIC SERVICE.

(a) GENERAL RULE.—*Paragraph (2) of section 3306(c) of the Internal Revenue Code of 1954 (defining employment) is amended to read as follows:*

"(2) domestic service in a private home, local college club, or local chapter of a college fraternity or sorority unless performed for a person who paid cash remuneration of $1,000 or more to individuals employed in such domestic service in any calendar quarter in the calendar year or the preceding calendar year;".

(b) EFFECTIVE DATE.—*The amendment made by subsection (a) shall apply with respect to remuneration paid after December 31, 1977, for services performed after such date.*

SEC. 114. DEFINITION OF EMPLOYER.

(a) GENERAL RULE.—*Subsection (a) of section 3306 of the Internal Revenue Code of 1954 (defining employer) is amended to read as follows:*

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

"(1) IN GENERAL.—*The term 'employer' means, with respect to any calendar year, any person who—*

"(A) *during any calendar quarter in the calendar year or the preceding calendar year paid wages of $1,500 or more, or*

"(B) *on each of some 20 days during the calendar year or during the preceding calendar year, each day being in a different calendar week, employed at least one individual in employment for some portion of the day.*

For purposes of this paragraph, there shall not be taken into account any wages paid to, or employment of, an employee performing domestic services referred to in paragraph (3).

"(2) AGRICULTURAL LABOR.—*In the case of agricultural labor, the term 'employer' means, with respect to any calendar year, any person who—*

"(A) *during any calendar quarter in the calendar year or the preceding calendar year paid wages of $20,000 or more for agricultural labor, or*

[4] "(B) *on each of some 20 days during the calendar year or during the preceding calendar year, each day being in a different calendar week, employed at least 10 individuals in employment in agricultural labor for some portion of the day.*

"(3) DOMESTIC SERVICE.—*In the case of domestic service in a private home, local college club, or local chapter of a college fraternity or sorority, the term 'employer' means, with respect to any calendar year, any person who during any calendar quarter in the calendar year or the preceding calendar year paid wages in cash of $1,000 or more for such service.*

"(4) SPECIAL RULE.—*A person treated as an employer under paragraph (3) shall not be treated as an employer with respect to wages paid for any service other than domestic service referred to in paragraph (3) unless such person is treated as an employer under paragraph (1) or (2) with respect to such other service.*"

(b) TECHNICAL AMENDMENT.—*Subsection (a) of section 6157 of such Code (relating to payment of Federal unemployment tax on quarterly or other time period basis) is amended to read as follows:*

"(a) GENERAL RULE.—*Every person who for the calendar year is an employer (as defined in section 3306 (a)) shall—*

"(1) *if the person is such an employer for the preceding calendar year (determined by only taking into account wages paid and employment during such preceding calendar year), compute the tax imposed by section 3301 for each of the first 3 calendar quarters in the calendar year on wages paid for services with respect to which the person is such an employer for such preceding calendar year (as so determined), and*

"(2) *if the person is not such an employer for the preceding calendar year with respect to any services (as so determined), compute the tax imposed by section 3301 on wages paid for services with respect to which the person is not such an employer for the preceding calendar year (as so determined)—*

"(A) *for the period beginning with the first day of the calendar year and ending with the last day of the calendar quarter (excluding the last calendar quarter) in which such person becomes such an employer with respect to such services, and*

"(B) *for the third calendar quarter of such year, if the period specified in subparagraph (A) includes only the first two calendar quarters of the calendar year.*

The tax for any calendar quarter or other period shall be computed as provided in subsection (b) and the tax as so computed shall, except as otherwise provided in subsections (c) and (d), be paid in such manner and at such time as may be provided in regulations prescribed by the Secretary."

(c) EFFECTIVE DATE.—*The amendments made by this section shall apply with respect to remuneration paid after December 31, 1977, for services performed after such date.*

And the Senate agree to the same.

Amendment numbered 4:

That the House recede from its disagreement to the amendment of the Senate numbered 4 and agree to the same with an amendment as follows:

[5] In lieu of the matter proposed to be stricken out by the Senate amendment, strike out line 14 on page 11 of the House bill and all that follows down through line 13 on page 12, and after line 13 on page 11 of the House bill insert the following:

(1) Subparagraph (A) of section 3304(a)(6) of such Code is amended by striking out "except that" and all that follows down through ", and" at the end thereof and inserting in lieu thereof the following:

except that—

"(i) *with respect to services in an instructional research, or principal administrative capacity for an educational institution to which section 3309(a)(1) applies, compensation shalll not be payable based on such services for any week commencing during the period between two successive academic years (or, when an agreement provides instead for a similar period between two regular but not successive terms, during such period) to any individual if such individual performs such services in the first of such academic years (or terms) and if there is a contract or reasonable assurance that such individual will perform services in any such capacity for any educational institution in the second of such academic years or terms, and*

"(ii) *with respect to services in any other capacity for an educational institution (other than an institution of higher education) to which section 3309(a)(1) applies, compensation payable on the basis of such services may be denied to any individual for any week which commences during a period between two successive academic years or terms if such individual performs such services in the first of such academic years or terms and there is a reasonable assurance that such individual will perform such services in the second of such academic years or terms. and*"

And the Senate agree to the same.

Amendment numbered 15:

That the House recede from its disagreement to the amendment of the Senate numbered 15, and agree to the same with an amendment as follows:

Strike the matter proposed to be stricken by the Senate amendment and insert in lieu thereof the following:

* * * * *

[7] *SEC. 506. ELECTION OF LOCAL GOVERNMENTS TO USE REIMBURSEMENT METHOD.*

(a) IN GENERAL.—*Paragraph (2) of section 3309(a) of the Internal Revenue Code 1954 (relating to State law requirements) is amended—*

(1) by striking out "an organization" and inserting in lieu thereof "a governmental entity or any other organization",

(2) by striking out "paragraph (1)(A)" and inserting in lieu thereof "paragraph (1)", and

(3) by striking out "that organizations" and inserting in lieu thereof "that governmental entities or other organizations".

(b) TECHNICAL AMENDMENT.—*Subparagraph (B) of section 3304(a)(6) of such Code is amended by striking out "section 3309(a)(1)(A)" and inserting in lieu thereof "section 3309(a)(1)".*

(c) EFFECTIVE DATE.—*The amendments made by this section shall apply with respect to certifications of States for 1978 and subsequent years, but only with respect to services performed after December 31, 1977.*

* * * * *

[9] JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill H.R. 10210 to require States to extend unemployment compensation coverage to certain previously uncovered workers; to increase the amount of wages subject to the Federal unemployment tax; to increase the rate of such tax; and for other purposes, submit the following joint statement to the House and the Senate in explanation of the effect of the action (other than action of a merely technical nature) agreed upon by the managers and recommended in the accompanying conference report:

SENATE AMENDMENT NUMBERED 1

COVERAGE OF CERTAIN AGRICULTURAL UNEMPLOYMENT

House bill.—Under existing law, agricultural employment is excluded from the definition of the term "employment" and is therefore not subject to the Federal unemployment tax. The House bill amends the definition of employment so as to include agricultural labor which is performed for farm employers who, during the current or preceding calendar year, employ four or more workers in each of 20 weeks, or pay $10,000 or more in wages for agricultural labor in a calendar quarter. The House bill excludes from the new coverage agricultural labor performed by aliens admitted to the United States to perform agricultural labor under a contract to an employer and who return to their own country upon completion of the contract. This exclusion is a temporary exclusion which expires on January 1, 1980. The provisions of the House bill apply with respect to remuneration paid after December 31, 1977, for services performed after such date.

Senate amendment.—The Senate amendment strikes out this provision of the House bill.

Conference agreement.—The conference agreement follows the House bill except agricultural labor is covered only if performed for a farm employer who, during the current or preceding calendar year, employs 10 or more workers in each of 20 weeks, or pays $20,000 or more in wages for such labor in any calendar quarter.

TREATMENT OF CERTAIN FARM WORKERS

House bill.—The House bill contains special rules for determining who will be treated as the employer, and, therefore, liable for the Federal unemployment tax, in the case of agricultural workers who are members of a crew furnished by a crew leader to perform agricultural [10] labor for a farm operator. These special rules are required by reason of the extension of coverage for farm workers which is contained in the House bill. Generally, the House bill provides that the crew leader will be treated as the employer of the individuals furnished by him to perform agricultural labor for another person only if such crew leader is registered under the Farm Labor Contractor Registration Act of 1963, or if substantially all of the members of the crew furnished by such crew leader operate or maintain mechanized equipment. In other cases, the farmer is to be treated as the employer. These provisions apply with respect to remuneration paid after December 31, 1977, for services performed after such date.

Senate amendment.—The Senate amendment strikes out the House provisions.

Conference agreement.—The conference agreement follows the House bill.

COVERAGE OF DOMESTIC SERVICE

House bill.—Under existing law, domestic services performed in a private home, local college club, or local chapter of a college fraternity, or sorority are not subject to the Federal unemployment tax. The House bill provides that such services will be subject to the Federal unemployment tax if they are performed for a person who pays cash remuneration of $600 or more to individuals employed in domestic services in any calendar quarter in the current calendar year or the preceding calendar year. This provision applies with respect to remuneration paid after December 31, 1977, for services performed after such date.

Senate amendment.—The Senate amendment strikes out the provisions of the House bill.

Conference agreement.—The con-

ference agreement follows the House bill except that domestic services is only covered if performed for an employer who pays $1,000 or more to individuals employed in such services in any calendar year in the calendar quarter year or the preceding calendar year.

DEFINITION OF EMPLOYER

House bill.—The House bill contains a technical amendment to the definition of employer for purposes of the Federal unemployment tax to conform that definition with the new extensions of coverage which are contained in the House bill. The House bill also contains a technical amendment to the requirement that employers pay the Federal unemployment tax on a quarterly basis which is necessary to conform that provision to the extensions of coverage contained in the House bill. These provisions apply with respect to remuneration paid after December 31, 1977 for services performed after such date.

Senate amendment.—The Senate amendment strikes out the provisions of the House bill.

Conference agreement.—The conference agreement follows the House bill.

[11]SENATE AMENDMENTS NUMBERED 2 AND 3

COVERAGE OF CERTAIN SERVICE PERFORMED FOR NONPROFIT ORGANIZATIONS AND STATE AND LOCAL GOVERNMENTS

House bill.—Under existing law, States are required, as a condition for approval of their unemployment compensation laws, to provide unemployment compensation coverage to individuals performing certain services for nonprofit organizations and for State hospitals and institutions of higher education. The House bill generally requires States to provide unemployment compensation coverage to all employees of State and local governments. The exceptions in the House bill to this general coverage are services performed by employees in the exercise of their duties as: elected officials, appointed officials whose terms are specified by law or who are not required to work on a full-time basis, members of legislative bodies or of the judiciary, members of the State National Guard or Air National Guard, certain employees hired during certain emergencies, and inmates of custodial or penal institutions. These provisions apply with respect to services performed after December 31, 1977.

Senate amendment.—The Senate amendment is the same as the House bill except that it deletes the House provision which excludes from the required coverage appointed officials who serve for a specific term established by law or who are not required to perform services on a substantially full-time basis. In lieu of this exception, the Senate amendment provides an exception for individuals who perform services in a position which, under or pursuant to the State law, is designated as a major nontenured policymaking or advisory position, or as a policymaking or advisory position the performance of the duties of which ordinarily does not require more than eight hours per week.

Conference agreement.—The conference agreement follows the Senate amendment.

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[13] SENATE AMENDMENTS NUMBERED 13 AND 14

INCREASE IN FEDERAL UNEMPLOYMENT TAX WAGE BASE AND RATE

House bill.—The House bill increases both the taxable wage base and the tax rate of the Federal unemployment tax. The taxable wage base is increased from $4,200 to $6,000. The Federal unemployment tax rate is increased from 3.2 percent of taxable wages to 3.4 percent. This tax rate increase is a temporary measure that will expire on January 1, 1983, or, if earlier, January 1 of the first calendar year after 1976 as of which there are no outstanding repayable advances to the extended unemployment compensation account in the Federal unemployment trust fund. The increase in the taxable wage base applies with respect to remuneration paid after December 31, 1977. The increase in the tax rate applies to remuneration paid after December 31, 1976.

Senate amendment.—The Senate amendments are the same as the House bill except that the Senate amendment provides that the increase in the tax rate will only expire when all of the repayable advances to the extended unemployment compensation account in the Federal unemployment trust fund are repaid.

Conference agreement.—The conference agreement follows the Senate amendment.

* * * * *

Public Law 94-568
94th Congress, H.R. 1144[1]
October 20, 1976

An act to amend the Internal Revenue Code of 1954 with respect to the tax treatment of social clubs and certain other membership organizations, to provide for a study of tax incentives for recycling, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 501(c)(7) of the Internal Revenue Code of 1954 (relating to exempt organizations) is amended to read as follows:

"(7) Clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder."

(b) Section 512(a)(3)(A) of such Code (relating to unrelated business taxable income) is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the deductions provided by sections 243, 244, and 245 (relating to dividends received by cor-

[1] Senate Report No. 94-1318, page 597; House Report No. 94-1353 is not published.

orations) shall be treated as not directly connected with the production of gross income."

(c) Section 277(a) of such Code (relating to deductions incurred by certain membership organizations in transactions with members) is amended by adding at the end thereof the following new sentence: "The deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall not be allowed to any organization to which this section applies for the taxable year."

(d) The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 2. (a) Section 501 of the Internal Revenue Code of 1954 (relating to exemption from tax on corporations, certain trusts, etc.) is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

"(g) PROHIBITION OF DISCRIMINATION BY CERTAIN SOCIAL CLUBS.—Notwithstanding subsection (a), an organization which is described in subsection (c)(7) shall not be exempt from taxation under subsection (a) for any taxable year if, at any time during such taxable year, the charter, bylaws, or other governing instrument, of such organization or any written policy statement of such organization contains a provision which provides for discrimination against any person on the basis of race, color, or religion."

(b) The amendment made by subsection (a) shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 3. (a) Paragraph (2) of section 301(g) of the Tax Reform Act of 1976 (relating to effective date for minimum tax provisions) is amended to read as follows:

"(2) TAX CARRYOVER.

"(A) IN GENERAL.—Except as provided in subparagraph (B), the amount of any tax carryover under section 56(c) of the Internal Revenue Code of 1954 from a taxable year beginning before January 1, 1976, shall not be allowed as a tax carryover for any taxable year beginning after December 31, 1975.

"(B) Except as provided by paragraph (4) and in section 56(e) of the Internal Revenue Code of 1954, in the case of a corporation which is not an electing small business corporation (as defined in section 1371(b) of such Code) or a personal holding company (as defined in section 542 of such Code), the amount of any tax carryover under section 56(c) of such Code from a taxable year beginning before July 1, 1976, shall not be allowed as a tax carryover for any taxable year beginning after June 30, 1976.".

(b) The amendments made by subsection (a) shall take effect on the date of the enactment of the Tax Reform Act of 1976.

SEC. 4. (a) The Secretary of the Treasury, in cooperation with the Administrator of the Environmental Protection Agency, shall make a thorough and complete study and investigation of all provisions of the Internal Revenue Code of 1954 which currently impede or discourage the recycling of solid waste materials, and shall determine what actions Congress may take under the internal revenue laws to increase and encourage the recycling of solid waste materials.

(b) The Secretary of the Treasury shall report his findings, together with specific legislative proposals and detailed revenue cost estimates, to the President and to the Congress at the earliest practicable date, but not later than six months after the date of the enactment of this Act.

Approved October 20, 1976.

Senate Report No. 94-1318
2d Session

[Bracketed numerals indicate official report page numbers]

TAX TREATMENT OF SOCIAL CLUBS AND OTHER MEMBERSHIP ORGANIZATIONS AND CERTAIN OTHER COMMITTEE AMENDMENTS

September 28, 1976

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 1144.[1]

The Committee on Finance, to which was referred the bill (H.R. 1144) to amend the Internal Revenue Code of 1954 with respect to the tax treatment of social clubs and certain other membership organizations, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

I. SUMMARY

The House-passed bill, H.R. 1144, amends the requirements for tax exemption for social clubs and similar organizations (including college fraternities and sororities) in two respects. First, it provides that "substantially all" of such an organization's activities must be for pleasure, recreation, and other nonprofitable purposes. This change (present law requires such an organization to be organized and operated "exclusively" for these purposes) allows the organization to earn income from nonmember sources to a limited extent and to have a limited amount of investment income (both types of income being subject to tax) without losing its general exemption from income tax. The second change provides that such an organization is to lose its tax-exempt status if its charter, by-laws, or other governing instrument or any of its written policy statements contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

In addition, the House-passed bill resolves a question about the corporate dividends-received deduction in the case of organizations which are generally exempt but which nevertheless are taxed on their investment income. It disallows this deduction in computing the [2] taxable investment income of social clubs, and similar organiza-

[1] Public Law 94-568, page 596.

tions, and of employee beneficiary associations. Similarly, it denies the dividends received deduction for investment income of taxable membership organizations.

The committee agreed to the House-passed bill and in addition added two amendments. The first amendment corrects a technical defect in the Tax Reform Act of 1976 relating to changes in the minimum tax in the case of corporations. Under this amendment any carryover of taxes paid from fiscal years beginning before July 1, 1976, is disallowed as a deduction in the case of the minimum tax on corporations for taxable years beginning after June 30, 1976.

The second committee amendment deals with the treatment of recycling of solid waste materials. It directs the Secretary of the Treasury and the Administrator of the Environmental Protection Agency to conduct a study and investigation of all matters relating to the proper role of the Federal Government in encouraging the recycling of solid waste materials.

II. GENERAL EXPLANATION

A. Social Clubs

1. Income from nonmembers and investment sources

Present law

Among the present law categories of exempt organizations are social clubs and other somewhat similar nonprofit organizations, such as national organizations of college fraternities and sororities. Present law (sec. 501(c)(7)) provides that these organizations must be organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes with no part of the net earnings inuring to the benefit of any private shareholder. The regulations under this provision (Regs. § 1.501(c)(7)-1(b)) state that a club which engages in business is not organized and operated exclusively for nonprofitable purposes and, therefore, is not exempt.

Generally, the Internal Revenue Service has not challenged the exempt status of these organizations if the income derived from providing goods and services to persons other than members and their guests is small in relation to the total activities of the organization. Thus, as an audit standard (Rev. Proc. 71-17, 1971-1 CB 683), the Service has indicated that it generally will not disturb a social clubs, certain fraternities and sororities, and employees' beneficiary if the club's annual income from outside sources either is not more than $2,500 or is not more than 5 percent of the total gross receipts of the organization. Where gross receipts from nonmembers dealings exceed this 5-percent figure, all facts and circumstances are taken into account in determining whether the organization continues to qualify for exempt status. In the case of investment income, the Service applies no percentage rule, but instead looks to whether a substantial part of the club's income is from investment sources club's exempt status solely on the basis of its nonmember activities (Rev. Rul. 66-149, 1966-1 CB 146).

[3] *Reasons for change*

In the Revenue Act of 1950, because of the competitive problem with taxable businesses, Congress imposed the regular income tax on the income certain tax-exempt organizations receive from active business enterprises which are unrelated to their exempt purposes. Social clubs, national organizations of college fraternities and sororities, and certain other types of tax-exempt organizations were not subjected to the unrelated business income tax imposed at that time.

In its consideration of the Tax Reform Act of 1969 [1969-3 C.B.], however, because many of the exempt organizations not subject to the unrelated business income tax were engaging in substantial business activity, Congress extended the unrelated business income tax to virtually all of the exempt organizations not already subject to that tax. As a result, social clubs and national organizations of college fraternities and sororities became taxable on all of their unrelated business income.

In addition, the 1969 Act extended the unrelated business income tax, in the case of these social clubs and national organizations of college fraternities and sororities, to cover investment income as well as unrelated business income. Investment income was made taxable in the case of these membership organizations because not to do so would have permitted them to provide recreational or social facilities and services out of revenues other than membership fees and as a result would have permitted individuals to devote investment income, free of tax, to personal activities.

Because of the personal nature of these organizations, the Internal Revenue Service in prior years developed the 5-percent test referred to above in determining whether a social club was properly exempt from tax. Not to have significantly limited the income which could be derived from nonmembers, under the conditions prevailing at that time, would have resulted in nontaxed income being devoted to the personal, recreational, or social benefit of the members of these clubs.

However, since the passage of the 1969 Act, this strict line of demarcation between the exempt and nonexempt activities of social clubs appears unnecessary. Since the passage of the 1969 Act all of the income derived from nonmembers as well as investment income is subject to tax, even though the organization itself is still classified as an exempt organization. Thus, while it is necessary to require that a social club must still be substantially devoted to the personal, recreational, or social benefit of members, the extent to which such a club can obtain income from nonmember sources can be somewhat liberalized. In view of these considerations the committee's bill clarifies existing law to permit somewhat larger amounts of income to be derived by exempt social clubs from nonmembers and also from investment income sources.

Explanation of provision

The first change made by the bill substitutes for the requirement of existing law that clubs which are exempt from tax under sec. 501(c)(7) must be organized and operated "exclusively" for pleasure, recreation, and other nonprofitable purposes, the new requirement that "substantially all" of such a club's activities must be for these purposes.[1]

[4] The effect of this change is twofold. First, it is intended to make it clear that these organizations may receive some outside income, including investment income, without losing their exempt status. Second, it is intended that a social club be permitted to derive a somewhat higher level of income than was previously allowed from the use of its facilities or services by nonmembers without the club losing its exempt status. The decision in each case as to whether substantially all of the organization's activities are related to its exempt purposes is to continue to be based on all the facts and circumstances. However, the facts and circumstances approach is to apply only if the club earns more than is permitted under the new guidelines. If the outside income is less than the guidelines permit, then the club's exempt status will not be lost on account of nonmember income.

It is intended that these organizations be permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside of their membership without losing their tax-exempt status. It is also intended that within this 35-percent amount not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. In effect, this latter modification increases from 5 percent (current audit standard: Rev. Proc. 71-17) to 15 percent the proportion of gross receipts a club may receive from making its club facilities available to the general public without losing its exempt status. This also means that a club exempt from taxation described in sec. 501(c)(7) is to be permitted to receive up to 35 percent of its gross receipts from a combination of investment income and receipts from nonmembers so long as the latter do not represent more than 15 percent of total receipts.

Gross receipts are defined for this purpose as those receipts from normal and usual activities of the club (that is, those activities they have traditionally conducted) including charges, admissions, membership fees, dues, assessments, investment income (such as dividends, rents, and similar receipts), and normal recurring capital gains on investments, but excluding initiation fees and capital contributions. However, where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facility, that income is not to be included in the formula; that is, such unusual income is not to be included in either the gross receipts of the club or in the permitted 35- or 15-percent allowances. On the other hand, where college fraternities or sororities charge membership initiation fees, but no annual dues, such fees will be included in their gross receipts, notwithstanding that initiation fees are ordinarilly excluded. It is not intended that these organizations should be permitted to receive, within the 15- or 35-percent allowances, income from the active conduct of businesses not traditionally carried on by these organizations.

It is intended that a social club, national organization of a college fraternity or sorority, and any other organization exempt under section 501(c)(7), may receive the full 35-percent amount of its gross receipts from investment income sources (reduced by any amount of nonmember income, discussed above). This means that a national organization of a college fraternity or sorority that has no outside income from permitting the general public to use its facilities may receive investment income up to the full 35-percent amount of its gross receipts. On the other hand, in the case where a social club [5] permits nonmembers to use its club facilities and receives 15 percent of its gross receipts from these nonmember sources, it may receive only up to 20 percent of its gross receipts from investment income.

In the case of the application of the unrelated business income tax to investment income of these organizations, present law (sec. 512(a)(3)) exempts that income which is set aside to be used for religious, charitable, scientific, literary, educational, etc., purposes (the purposes specified in sec. 170(c)(4)) or the reasonable cost of administration of these activities. For purposes of the 35-percent test, this exempt function income should be included in both the numerator and the denominator, and if this exempt function income causes the organization to exceed the 35-percent limit, the organization is to lose its exempt status (unless the facts and circumstances of the case warrant otherwise).

If an organization has outside income in excess of the 35-percent limit (or 15-percent limit in the case of gross receipts derived from nonmember use of a club's facilities), all the facts and circumstances are to be taken into account in determining whether the organization qualifies for exempt status. If it is determined that the organization is to lose its exempt status for that year, all of its income, even that received from its membership, is to be subject to tax in that year. In such a case the income received from the club's members (but only this income) could be offset by the cost of services and goods furnished the members (sec. 277).

2. DIVIDENDS RECEIVED DEDUCTION FOR EXEMPT SOCIAL CLUBS, ETC.

Present law

Generally, the tax on unrelated business income does not apply to in-

[1] The bill continues the present law requirement that no part of the net earnings of the organization may inure to the benefit of any private shareholder.

vestment income.[2] However, in the case of social clubs, certain fraternities and sororities, and employees' beneficiary associations, "investment income" is included in the tax base. This result is accomplished in the case of these organizations by defining their unrelated business taxable income (sec. 512(a)(3)) as meaning gross income (other than exempt function income)[3] less allowable deductions directly connected with the production of gross income (again excluding exempt function income).

One of the deductions allowed corporations in the computation of the regular corporate income tax is the dividends received deduction. Generally, this allows corporations a deduction equal to 85 percent of dividends received from taxable domestic corporations. The proposed Treasury regulations on social clubs, certain fraternities and sororities, and employees' beneficiary associations[4] provide that the dividends received deduction is not allowed for purposes of computing unrelated business taxable income for those organizations, because that deduction is not an expense directly connected with the production of income.

[6] *Reasons for change*

Treasury representatives have reported that questions have been raised with respect to these proposed regulations, as to whether Congress intended to disallow the dividends received deduction. To clarify this point the Treasury Department has requested Congress to state specifically that the dividends received deduction is not available in the case of investment income of tax-exempt social clubs, certain fraternities and sororities, and employees' beneficiary associations.

The major reason for the dividends received deduction is to avoid two or more corporate taxes on corporate earnings as the income is passed from one corporation to another, in addition to taxing the same amount to individual shareholders when the earnings are paid out as dividends to them. In the case of social clubs, certain fraternities and sororities, and employees' beneficiary associations, however, the individual income tax on shareholders does not apply, since the dividend income received by these organizations is not distributed to the members. Since the exempt organization is in effect taking the place of the individual member for tax purposes, it seems appropriate that the tax apply to these organizations in much the same manner as in the case of individual shareholders.

For reasons indicated above, the committee believes that the proposed Treasury regulations disallowing the dividends received deduction are consistent with the intent and structure of the provisions (sec. 512(a)(3)) enacted in the Tax Reform Act of 1969, which allows deductions in the case of investment income of social clubs, certain fraternities and sororities, and employees' beneficiary associations only in the case of deductions directly connected with the production of income. The bill specifically clarifies this point by providing that in these cases the dividends received deduction is not to be considered as directly connected with the production of gross income.

Explanation of provision

The second change made by this bill denies a corporate dividends received deduction to tax-exempt social clubs, certain fraternities and sororities, and voluntary employees' beneficiary associations (described in secs. 501(c)(7) and (9)) in computing their "unrelated business taxable income." Under present law the unrelated business taxable income of these organizations is defined as their gross income (excluding any exempt function income) less the deductions under this chapter "which are directly connected with the production of the gross income" (again excluding exempt function income). The bill specifically provides that the corporate dividends received deduction is not to be considered as a deduction which is "directly connected with the production of gross income."

3. DIVIDENDS RECEIVED DEDUCTION FOR NONEXEMPT MEMBERSHIP ORGANIZATIONS

Present law

Under present law (sec. 277, enacted as part of the Tax Reform Act of 1969), in the case of taxable membership organizations the deduction for expenses incurred in supplying services, facilities, or goods to the members is to be allowed only to the extent of the income [7] received from these members. This was provided in order to prevent taxable membership organizations from escaping tax on business or investment income by using this income to provide services, facilities, or goods to its members at less than cost and then deducting the loss from the membership activity against the business or investment income.

Reasons for change

To the extent these organizations receive dividend income which is used to provide services, facilities, or goods to the members the same problem arises in connection with these taxable membership organizations as in the case of the tax-exempt membership organizations described above (sec. 2. Dividends Received Deduction for Exempt Social Clubs, etc.). If the dividends received deduction were available in the case of the tax on the membership organization (in effect, providing a substitute for the dividend tax on shareholders) the second, or individual, tax on this income would be avoided in substantially the same way as in the case of the exempt membership organizations (were the provision described above not to be added). Moreover, if

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[2] Section 512(b) generally excludes from the term "unrelated business taxable income" passive investment income such as dividends, interest, royalties, and capital gains.

[3] Exempt function income is defined in section 512(a)(3)(B) as gross income from dues, fees, charges, or similar amounts paid by members in connection with the purposes constituting the basis for the exemption of the organization.

[4] Proposed Reg. § 1.512(a)-3(b)(2), published on May 13, 1971 (36 Fed. Reg. 8808-8809).

nothing were done in this regard in the case of taxable membership organizations, the nontaxable organizations by revoking their exempt status could avoid the tax on this dividend income in this manner.

For the reasons indicated above, the committee believes it is appropriate to disallow the dividends received deductions in the case of these taxable membership organizations in the same manner as in the case of the tax-exempt membership organizations referred to above.

Explanation of provision

The third change made by this bill denies a corporate dividends received deduction to taxable social clubs and other membership organizations operated primarily to furnish services or goods to members (referred to in sec. 277). These organizations, with certain exceptions set forth in present law, are permitted deductions attributable to furnishing services, insurance, goods, or other items of value to their members only to the extent of the income derived from members or transactions with members. The bill specifically provides that the corporate divdends received deduction (secs. 243, 244, and 245) is not to be allowed to these organizations.

4. PROHIBITION OF DISCRIMINATION BY SOCIAL CLUBS, ETC.

Present law

The Internal Revenue Code does not deal explicitly with the question of whether an income tax exemption for social clubs, etc. (i.e., organizations described in sec. 501(c)(7) which are exempt under sec. 501(a)), is incompatible with discrimination on account of race, color, or religion.

It has been held (*McGlotten* v. *Connally*, 338 F. Supp. 448 (D.C., D.C. 1972)) that, in light of the present statutory scheme of income tax treatment of social clubs, etc. (including their treatment under the unrelated business income tax provisions described above), discrimination on account of race is not prohibited under the Constitution in [8] the case of an exempt organization merely because it is described in section 501(e)(7).[5]

Reasons for change

In view of national policy, it is believed that it is inappropriate for a social club or similar organization described in section 501(c)(7) to be exempt from income taxation if its written policy is to discriminate on account of race, color, or religion.

Explanation of provision

Under the bill, an organization otherwise exempt from income tax as an organization described in section 501(c)(7) is to lose its exempt status for any taxable year if, at any time during that year, the organization's charter, by-laws, or other governing instrument, or any written policy statement contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

5. EFFECTIVE DATES

The amendments made by the bill relating to social clubs generally apply to taxable years beginning after the date of enactment of this Act.

The amendment as to income from nonmembers and investment sources, and the amendments as to the corporate dividends received deductions are intended as clarifications of existing law under the Tax Reform Act of 1969.

B. EFFECTIVE DATE FOR REPEAL OF TAX CARRYOVERS IN THE CASE OF THE MINIMUM TAX ON CORPORATIONS

The committee added an amendment to the bill which corrects a technical defect in the Tax Reform Act of 1976. The provision of that Act relating to changes in the minimum tax on individuals and corporations (sec. 301) provided that no amount of any carryover of regular taxes paid (which, under prior law, was allowed as a deduction in determining the amount subject to the minimum tax in subsequent years) would be allowed from a taxable year begnning before January 1, 1976, to any taxable year beginning after December 31, 1975. This same provision was in the bill as passed by the Senate, except that for corporations (other than subchapter S corporations and personal holding companies) the Senate bill applied to carryovers from taxable years beginning before July 1, 1976, to taxable years beginning after June 30, 1976. Since the House-passed bill had no provision limiting tax carryovers for corporations, the change in the Senate date to January 1, 1976, for corporations was a technical error. The amendment of the committee to this bill merely conforms the effective date of this provision of the Tax Reform Act back to the same provision that was in the Senate bill, as agreed to by the [9] conferees. Thus, for corporations (other than subchapter S corporations and personal holding companies) any carryover of regular taxes paid from a taxable year beginning before July 1, 1976, is not to be allowed as a carryover for any taxable year beginning after June 30, 1976. For individuals the provision remains the same as provided in the Tax Reform Act that carryovers from taxable years beginning before January 1, 1976, are not to be allowed in taxable years beginning after December 31, 1975.

C. STUDY OF RECYCLING INCENTIVES

Present law

There is no provision in present law providing for any tax incentives to encourage salvage and reclaiming of materials as a means to conserve natural resources, reduce energy consumption, and reduce environmental litter. In sections 611 and 613 of the code, a

[5] In that same decision, the court held that, in the case of fraternal beneficiary societies operating under the lodge system, discrimination on account of race is inconsistent both with such an organization's tax-exempt status (sec. 501(c)(8); this may also apply as to sec. 501(c)(10)) and also with its status as a limited charitable contribution donee (sec. 170(c)(4)).

Also, the Supreme Court has affirmed (*Coit* v. *Green*, 404 U.S. 997 (1971)) a decision (*Green* v. *Connally*, 330 F. Supp. 1150 (D.C., D.C. 1971)) that discrimination on account of race is inconsistent with an educational institution's tax-exempt status (sec. 501(c)(3)) and also with its status as a charitable contribution donee (sec. 170(c)(2)).

schedule of percentage depletion rates is provided for varous metals and minerals to encourage their discovery, development and mining so that the metals and minerals may be made available for industrial use. Percentage depletion also is provided to the owners of these materials because they are irreplaceable assets. Capital gains treatment is available on timber income and on royalties from coal and iron ore.

Reasons for change

For the past two Congresses, many members of both bodies have introduced or supported legislation that would provide tax incentives for recycling solid waste materials. The motivation for the interest in tax incentives has been the proliferation of unsightly and unhealthy environmental litter, the need to conserve on the consumption of energy and prolong the availability of our existing fuel sources, and recognition of the need to reduce the rate of consumption of the limited supplies of various metallic and mineral resources.

The proposed tax incentives generally have taken the form of a tax credit that would be earned by those who perform the actual recycling. The amount of the credit generally has taken the form of a percentage of the price paid for recyclable materials multiplied by the volume of material purchased. Others have emphasized the necessity to increase the productive capacity of the industry and to achieve technology breakthroughs which would make economical the recycling of solid waste with relatively small amounts of recyclable matter.

Two versions of the recycling tax credit on purchases have been reported by the two tax-writing committees. The Committee on Ways and Means included a recycling tax credit in H.R. 6860, as reported by the committee, but the provision was deleted on the floor of the House. The Committee on Finance included a recycling tax credit in H.R. 10612, the Tax Reform Act of 1976, but it was replaced in the bill on the floor of the Senate by a substitute provision which requested that a study of the need for tax and other incentives be made by the Treasury Department and the Environmental Protection Agency. This provision was also eliminated in the conference report on H.R. 10612 since the conferees decided not to consider any of the energy provisions on the Tax Reform Act but to defer consideration until the energy bill (H.R. 6860) is sent to conference.

[10] In view of the interest in recycling incentives but in recognition of some of the concerns which have also been expressed, especially the related costs, the committee believes it is appropriate to provide a study of the recycling incentives. It is expected that this study, which is to be completed within six months, will provide the information necessary to assist the Congress in determining to what extent tax incentives would be appropriate in the case of recycling.

Explanation of provision

The Secretary of the Treasury, in cooperation with the Administrator of the Environmental Protection Agency, is directed to conduct a study and investigation of all matters relating to the proper role of the Federal Government in encouraging the recycling of solid waste materials. The study should include an examination of the feasibility and revenue effects of providing incentives and disincentives for recycling through the Internal Revenue Code. The study should also include an examination of the various types of solid wastes produced in the domestic economy, those materials which are now or could be recycled, the available technology and capacity for recycling those materials, the cost-competitiveness (with virgin production) of recycling for various materials, and potential governmental actions (both economic and noneconomic) which might increase the amount of recycling in the U.S. The Secretary is to report his findings, together with his recommendations for legislation, to the President and the Congress as soon as this study is completed, but no later than 6 months after the enactment of this bill.[6]

Effective date

The requirement for the study is effective as of the date of enactment of this bill.

III. EFFECT OF THE BILL ON THE REVENUES AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the effect of this bill on the revenues. The committee estimates that the provisions dealing with social clubs will result in a small revenue gain, probably less than $100,000 per year. The Treasury Department agrees with this statement. The change in the effective date for the repeal of tax carryovers in the case of the minimum tax on corporations will have no revenue effect because the revenue estimates for this provision in the Tax Reform Act of 1976 were based on the June 30, 1976, effective date which was intended for that Act, but which was changed by technical error. The study of recycling incentives will have no revenue impact.

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote of the committee on reporting the bill. The bill, as amended, was ordered favorably reported by the Committee by voice vote.

[11] IV. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with

[6] This provision is virtually identical to the amendment to the Tax Reform Act (H.R. 10162) which was offered by Senators Hart and Durkin. That amendment was a substitute for the Committee on Finance provision to provide a recycling tax credit. The only change from the Hart-Durkin amendment is to require that the report on the recycling study be submitted to Congress 6 months after the date of enactment.

the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

Public Law 94-569
94th Congress, H.R. 7228 [1]
October 20, 1976

An act to amend the Internal Revenue Code of 1954 to permit the authorization of means other than stamp on containers of distilled spirits as evidence of tax payment, to provide an extension of certain provisions relating to members of the Armed Forces missing in action, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 5205(h) of the Internal Revenue Code of 1954 (relating to form of stamps for containers of distilled spirits) is amended by striking out "or other form of stamp" and inserting in lieu thereof "other form of stamp, or other device".

* * * * *

SEC. 3. (a) SURVIVING SPOUSE.—Section 2(a)(3)(B) of the Internal Revenue Code of 1954 (relating to the special rule where a deceased spouse was in a missing status) is amended to read as follows:

"(B) the date which is—

"(i) January 2, 1978, in the case of service in the combat zone designated for purposes of the Vietnam conflict, or

"(ii) 2 years after the date designated under section 112 as the date of termination of combatant activities in that zone, in the case of any combat zone other than that referred to in clause (i).".

(b) CERTAIN PAY OF MEMBERS OF THE ARMED FORCES HOSPITALIZED AS A RESULT OF THE VIETNAM CONFLICT.—The last sentence of section 112(a) of such Code (relating to certain combat pay of enlisted members of the Armed Forces) and the last sentence of section 112(b) of such Code (relating to certain combat pay of commissioned officers of the armed forces) are each amended by striking out "beginning more than 2 years after the date of the enactment of this sentence" and inserting in lieu thereof "after January 1978".

(c) INCOME TAXES OF MEMBERS OF ARMED FORCES ON DEATH IN MISSING STATUS.—The second sentence of section 692(b) of such Code (relating to income taxes of members of the armed forces on death in a missing status) is amended to read as follows: "The preceding sentence shall not cause subsection (a)(1) to apply for any taxable year beginning—

"(1) after January 2, 1978, in the case of service in the combat zone designated for purposes of the Vietnam conflict, or

"(2) more than 2 years after the date designated under section 112 as the date of termination of combatant activities in that zone, in the case of any combat zone other than that referred to in paragraph (1).".

(d) JOINT RETURN WHERE INDIVIDUAL IS IN MISSING STATUS AS A RESULT OF VIETNAM CONFLICT.—The last sentence of section 6013(f)(1) of such Code (relating to joint returns where individual is in missing status as a result of the Vietnam conflict) is amended by striking out "more than 2 years after the date of the enactment of this sentence" and inserting in lieu thereof "after January 2, 1978".

(e) TIME FOR PERFORMING CERTAIN ACTS POSTPONED BY REASON OF VIETNAM CONFLICT.—The second sentence of section 7508(b) of such Code (relating to the application to a spouse of provision relating to the time for performing certain acts postponed by reason of war) is amended to read as follows: "The preceding sentence shall not cause this section to apply to any spouse for any taxable year beginning—

"(1) after January 2, 1978, in the case of service in the combat zone designated for purposes of the Vietnam conflict, or

"(2) more than 2 years after the date designated under section 112 as the date of termination of combatant activities in that zone, in the case of any combat zone other than that referred to in paragraph (1).".

* * * * *

Approved October 20, 1976.

[1] This publication of the law is restricted to excerpts involving tax matters other than taxes imposed under subtitle E of the Code; Senate Report No. 94-1319, this page, House Report No. 94-1071 is not published.

Senate Report No. 94-1319
2d Session

[Bracketed numerals indicate official report page numbers]

DEVICES OTHER THAN STAMPS ON DISTILLED SPIRITS CONTAINERS AS EVIDENCE OF TAX PAYMENTS AND EXTENSION OF TAX BENEFITS OF MEMBERS OF THE ARMED FORCES AND CIVILIAN EMPLOYEES WHO ARE MISSING IN ACTION OR HOSPITALIZED AS A RESULT OF THE VIETNAM CONFLICT

September 28, 1976

Mr. LONG, from the Committee on Finance, submitted the following report to accompany H.R. 7228.[1]

The Committee on Finance, to which was referred the bill (H.R. 7228) to amend the Internal Revenue Code of 1954 to permit the authorization of means other than stamps on containers of distilled spirits as evidence of tax payment, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

I. SUMMARY

* * * * *

The committee agreed to the House passed bill and added an amendment dealing with the special tax provisions relating to members of the Armed

[1] Public Law 94-569, this page.

Forces and others involved in the Vietnam conflict. The amendment extends for one year (to January 2, 1977) the tax relief to members of the Armed Forces of the United States (and their spouses) and civilian employees who are missing in action or hospital-[2]ized as a result of wounds, disease, or injury incurred in the Vietnam conflict.

II. General Statement

* * * * *

[3] B. EXTENSION OF TAX BENEFITS OF MEMBERS OF THE ARMED FORCES AND CIVILIAN EMPLOYEES WHO ARE MISSING IN ACTION OR HOSPITALIZED AS A RESULT OF THE VIETNAM CONFLICT

Present law

Under present law, members of the Armed Forces of the United States and civilian employees who are missing in action or remain hospitalized as a result of wounds, disease, or injury incurred in the Vietnam conflict are entitled to certain tax relief which generally will expire with respect to taxable years beginning after January 2, 1977.

Under section 112 of the Code, members of the Armed Forces may exclude from income compensation received for each month any part of which is spent hospitalized as a result of wounds, disease, or injury incurred in combat. Generally, these benefits run for two years after the formal cessation of hostilities, that is for two years after the date designated under section 112 as the date of termination of combatant activities. Public Law 93-597, enacted on January 2, 1975, extended the latest date for qualification for the exclusion provided by section 112 in cases relating to the Vietnam conflict through months beginning on or before January 2, 1977.

Present law (sec. 692 of the Code) also forgives any taxes otherwise due for a taxable year during which a member of the Armed Forces dies while on active duty in a combat zone or for any prior taxable year which ends after the member first served in a combat zone. In the case of members missing in the Vietnam conflict, the tax forgiveness provision will not apply to any taxable year beginning after January 2, 1977.

In addition, certain widows and widowers are eligible for special tax rates as a surviving spouse for the two taxable years following the year in which the other spouse died. In the case of spouses missing in the Vietnam conflict, the survivor may elect (under sec. 2 of the Code) the special rates for two years from the earlier of the date of the determination of death, or January 2, 1977. This allows the surviving spouse of an individual missing in Vietnam to elect the favorable "surviving spouse" rates for two taxable years after January 2, 1977.

Several provisions also affect the election to file a joint return by a spouse of a missing member. Under section 6013 the spouse of a member [4] missing as a result of the Vietnam conflict cannot elect to file a joint return for a taxable year beginning after January 2, 1977. The spouse of a missing individual is also granted extensions (under sec. 7508 of the Code) for certain tax obligations and tax administrative actions for taxable years beginning before January 2, 1977. For that period the Internal Revenue Service is to disregard whether required tax returns were filed, payments made, petitions and credit or refund claims filed, etc., within the time prescribed by statute.

Reasons for change

Since the enactment of the 1975 legislation, the Department of Defense has been unable to conduct status reviews of persons missing in action because of unanticipated events. Between 1973 and March, 1974, the Department was judicially enjoined from making such reviews. In March 1974, the Federal District Court (Southern District of New York) stated that status reviews could be resumed if the Department adopted procedural safeguards including notification of intention to review, providing an opportunity for primary next of kin to attend the hearing with legal counsel, and providing reasonable access to information used at the hearings.[1]

Following that decree, the military again began status reviews. These reviews were again suspended by agreement between the Department of Defense and the House Select Committee on Missing Persons in Southeast Asia until late 1976 or early 1977 when the Committee will submit its report to the House. Thus, no status reviews will be resumed on the remaining cases until 1977. The committee has been informed that a one-year extension of the tax benefits should allow the military sufficient time to complete reviewing the status of open cases.

Explanation of provision

The bill generally extends the termination date for the special tax treatment for certain individuals missing in action or remaining hospitalized as a result of the Vietnam conflict for one year through taxable years beginning on or before January 2, 1978.

Specifically, the bill would allow members of the Armed Forces to exclude from gross income compensation received for any month during any part of which the member was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone in the Vietnam conflict. Enlisted personnel may exclude all such compensation; commissioned officers may exclude up to $500 of such compensation per month. These exclusions would apply through January 1978.

The bill would also extend from January 2, 1977, to January 2, 1978, the date after which the income tax forgiveness for the taxable year in which a member of the Armed Forces dies (or is determined to have died) as a result of combat in the Vietnam conflict, will no longer be allowed.

Also, the spouse of a person missing

[1] *McDonald* v. *McLucas*, 371 F. Supp. 831 (1974); 371 F. Supp. 837 (1974); aff'd; 95 Sup. Ct. 297 (1974).

as a result of service in a combat zone in the Vietnam conflict would be allowed to elect to file a joint return until taxable years beginning after January 2, 1978, and would [5] be entitled to file as a surviving spouse for two taxable years beginning after January 2, 1978.

Effective date.—This provision will become effective on the date of enactment.

* * * * *

Part III. Administrative, Procedural, and Miscellaneous

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Ct. D. 1979

SUPREME COURT OF THE UNITED STATES
No. 74-1124

William E. Simon, Secretary of the Treasury, et al., Petitioners
v.
Eastern Kentucky Welfare Rights Organization et al.

No. 74-1110

Eastern Kentucky Welfare Rights Organization et al., Petitioners
v.
William E. Simon, Secretary of the Treasury, et al.

[426 U.S. 26]

On writs of certiorari to the United States Court of Appeals for the District of Columbia Circuit

[June 1, 1976]

Syllabus

Respondents in No. 74-1124 (hereinafter respondents), several low-income individuals and organizations representing such individuals, brought this class action in District Court on behalf of all persons unable to afford hospital services, against the Secretary of the Treasury and the Commissioner of Internal Revenue. They claimed that Revenue Ruling 69-545 [1969-2 C.B. 117], which announced an Internal Revenue Service policy of extending favorable tax treatment under the Internal Revenue Code of 1954 (the Code) to hospitals that did not serve indigents to the extent of their financial ability, "encouraged" hospitals to deny services to indigents, and was invalid because it was an erroneous interpretation of the Code and because it had been issued in violation of the Administrative Procedure Act (APA). The complaint described instances in which the individual respondents had been refused treatment, because of their indigency, at hospitals enjoying favorable tax treatment under the policy announced in the challenged Revenue Ruling and alleged to be receiving substantial contributions as a result of that treatment. The District Court overruled petitioners' motion to dismiss, which included a challenge to respondents' standing, and on cross-motions for summary judgment, held Revenue Ruling 69-545 void as contrary to the Code. The Court of Appeals also found standing in respondents, but upheld Revenue Ruling 69-545. *Held:* The District Court should have granted petitioners' motion to dismiss because respondents failed to establish their standing to bring this suit.

(a) When a plaintiff's standing is challenged the relevant inquiry is whether, assuming justiciability of the claim, the plaintiff has shown an injury to himself that is likely to be redressed by a favorable decision, and unless such a showing is made a federal court cannot exercise its power consistent with the "case or controversy" limitation of Art. III of the Constitution.

(b) The respondent organizations, which alleged no injury to themselves *qua* organizations, cannot establish standing simply on the basis that they are dedicated to promoting access of the poor to health services. An organization's abstract concern with a subject that could be affected by an adjudication does not substitute for the concrete injury required by Art. III. *Sierra Club* v. *Morton,* 405 U.S. 727.

(c) Allegations that the individual respondents and members of respondent organizations were denied hospital services because of indigency do not establish a case or controversy in this suit, which is not brought against any hospital but against Treasury officials. The Art. III "case or controversy" limitation requires that a federal court act only to redress injury that fairly can be traced to the challenged action of a defendant, and not solely to some third party.

(d) Though petitioners alleged that the adoption of Rev. Rul. 69-545 "encouraged" hospitals to deny services to indigents, it is purely speculative (1) whether the alleged denials of service are ascribable to petitioners' "encouragement" or resulted from the hospitals' decisions apart from tax considerations, and (2) whether the exercise of the District Court's remedial powers would make such services available to respondents. Respondents' allegation that the hospitals that denied them service receive substantial contributions, without more, does not establish that those hospitals are dependent upon such contributions. It thus appears that respondents relied "on little more than the remote possibility; unsubstantiated by allegations of fact, that their situation might have been better had [petitioners] acted otherwise, and might improve were the [District Court] to afford relief." *Warth* v. *Seldin,* 422 U.S. 490, 507. Consequently, respondents failed to carry their burden of showing that their injury is the consequence of petitioners' action or that prospective relief will remove the harm. *Warth* v. *Seldin, supra; Linda R. S.* v. *Richard D.,* 410 U.S. 614, followed.

U.S. App. D.C. —, 506 F. 2d 1278, vacated and remanded.

POWELL, J., delivered the opinion of the Court, in which BURGER, C. J., and STEWART, WHITE, BLACKMUN, and REHNQUIST, JJ., joined. STEWART J., filed a concurring statement. BRENNAN, J., filed an opinion concurring in the judgment and dissenting, in which MARSHALL, J., joined. STEVENS, J., took no part in the consideration or decision of the cases.

Mr. JUSTICE POWELL delivered the opinion of the Court.

Several indigents and organizations composed of indigents brought this suit against the Secretary of the Treasury and the Commissioner of Internal Revenue. They asserted that the Internal Revenue Service (IRS) violated the Internal Revenue Code (the Code) and the Administrative Procedure Act (APA) by issuing a Revenue Ruling allowing favorable tax treatment to a nonprofit hospital that offered only emergency room services to indigents. We conclude that these plaintiffs lack standing to bring this suit.

I

The Code, in its original version and by subsequent amendment, accords advantageous treatment to several types of nonprofit corporations, including exemption of their income from taxation and deductibility by benefactors of the amounts of their donations. Nonprofit hospitals have never received these benefits as a favored general category, but an individual nonprofit hospital has been able to claim them if it could qualify as a corporation "organized and operated exclusively for . . . charitable . . . purposes" within the meaning of § 501 (c)(3) of the Code, 26 U.S.C. § 501 (c)(3).[1] As the Code does not define

[1] Section 501 is the lynchpin of the statutory benefit system. 26 U.S.C. § 501. Subsection (a) states that organizations described in subsection (c) "shall be exempt from taxation under this subtitle. . . ." Among the organizations described in current subsection (c)(3) are nonprofit corporations "organized and operated exclusively for religious, *charitable,* scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals." Deduction by either an individual or a corporate taxpayer of a contribution to a nonprofit charitable corporation is allowed by §§ 170 (a), (c)(2). 26 U.S.C. §§ 170(a), (c)(2). Other indirect benefits to such a corporation, similar in nature to the benefit it derives from third-party deductibility of

the term *charitable,* the status of each nonprofit hospital is determined on a case-by-case basis by the IRS.

In recognition of the need of nonprofit hospitals for some guidelines on qualification as "charitable" corporations, the IRS in 1956 issued Rev. Rul. 56-185.[2] This Ruling established the position of the IRS to be "that the term 'charitable' in its legal sense and as it is used in § 501(c)(3) of the Code contemplates an implied public trust constituted for some public benefit. . . ." In addition, the Ruling set out four "general requirements" that a hospital had to meet, "among other things," to be considered a charitable organization by the IRS. Only one of those requirements is important here, and it reads as follows:

"It must be operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay. It is normal for hospitals to charge those able to pay for services rendered in order to meet the operating expenses of the institution, without denying medical care or treatment to others unable to pay. The fact that its charity record is relatively low is not conclusive that a hospital is not operated for charitable purposes to the full extent of its financial ability. It may furnish services at reduced rates which are below cost, and thereby render charity in that manner. It may also set aside earnings which it uses for improvements and additions to hospital facilities. It must not, however, refuse to accept patients in need of hospital care who cannot pay for such services. Furthermore, if it operates with the expectation of full payment from all those to whom it renders services, it does not dispense charity merely because some of its patients fail to pay for the services rendered."

Rev. Rul. 56-185 remained the announced policy with respect to a nonprofit hospital's "charitable" status for 13 years, until the IRS issued Rev. Rul. 69-545 on November 3, 1969.[3] This new Ruling described two unidentified hospitals, referred to simply as Hospital A and Hospital B, which differed significantly in both corporate structure and operating policies.[4] The description of Hospital A included the following paragraph:

"The hospital operates a full time emergency room and no one requiring emergency care is denied treatment. The hospital otherwise ordinarily limits admissions to those who can pay the cost of their hospitalization, either themselves, or through private health insurance, or with the aid of public programs such as Medicare. Patients who cannot meet the financial requirements for admission are ordinarily referred to another hospital in the community that does serve indigent patients."

Despite Hospital A's apparent failure to operate "to the extent of its financial ability for those not able to pay for the services rendered," as required by Rev. Rul. 56-185, the IRS in this new Ruling held Hospital A exempt as a charitable corporation under § 501(c)(3).[5] Noting that Rev. Rul. 56-185 had set out requirements for serving indigents "more restrictive" than those applied to Hospital A, the IRS stated that "Rev. Rul. 56-185 is hereby modified to remove therefrom the requirements relating to caring for patients without charge or at rates below cost."

II

Issuance of Rev. Rul. 69-545 led to the filing of this suit in July 1971 in the United States District Court for the District of Columbia, by a group of organizations and individuals. The plaintiff organization described themselves as an unincorporated association[6] and several nonprofit corporations[7] each of which included low-income persons among its members and represented the interests of all such persons in obtaining hospital care and services. The 12 individual plaintiffs[8] described themselves as subsisting below the poverty income levels established by the Federal Government and suffering from medical conditions requiring hospital services. The organizations sued on behalf of their members, and each individual sued on his own behalf and as representative of all other persons similarly situated.

Each of the individuals described an occasion on which he or a member of his family had been disadvantaged in seeking needed hospital services because of indigency. Most involved the refusal of a hospital to admit the person because of his inability to pay a deposit or an advance fee, even though in some instances the person was enrolled in the Medicare program. At least one plaintiff was denied emergency-room treatment because of his inability to pay immediately. And an-

contributions, are provided by various other sections of the Code. See 26 U.S.C. §§ 642(c), 2055(a)(2), 2106(a)(2)(A)(ii), 2522(a)(2) and b(2).

[2] 1956-1 Cum. Bull. 202.

[3] 1969-2 Cum. Bull. 117. The substance of this Ruling had been issued as a policy pronouncement approximately one month earlier. Technical Info. Rel. No. 1022 (Oct. 8, 1969).

[4] The descriptions fit, in whole or in part, actual hospitals as to whose tax status either a taxpayer or an IRS field office had requested advice. The anonymous reference to the hospitals in Revenue Ruling 69-545 conformed to the IRS practice of deleting "identifying details and confidential information" contained in such requests, which are dealt with privately before the underlying fact situation is used in a published Revenue Ruling. See 1969-2 Cum. Bull. xxii.

[5] In reaching this conclusion the IRS cited the law of trusts for the premise that promotion of health was a "charitable" purpose provided only that the class of direct beneficiaries was sufficiently large that its receipt of health services could be said to benefit the community as a whole. See Restatement (Second) Trusts §§ 368, 372 (——); IV Scott on Trusts §§ 368, 372 (3d ed. 1967). The IRS then applied that premise to Hospital A and concluded that by maintaining an open emergency room and providing hospital care to all persons able to pay, either directly or through insurance, the hospital served a large enough class to qualify as charitable.

[6] California Welfare Rights Organization.

[7] Eastern Kentucky Welfare Rights Organization; National Tenants Organization; Association of Disabled Miners and Widows, Inc.; Health, Education, Advisory Team, Inc.

[8] One of the 12, a minor, sued by and through his parents, who also were named plaintiffs.

other was treated in the emergency room but then billed and threatened with suit although his indigency had been known at the time of treatment.

According to the complaint, each of the hospitals involved in these incidents had been determined by the Secretary and the Commissioner to be a tax-exempt charitable corporation, and each received substantial private contributions. The Secretary and the Commissioner were the only defendants. The complaint alleged that by extending tax benefits to such hospitals despite their refusals fully to serve the indigent, the defendants were "encouraging" the hospitals to deny services to the individual plaintiffs and to the members and clients of the plaintiff organizations. Those persons were alleged to be suffering "injury in their opportunity and ability to receive hospital services in nonprofit hospitals which receive . . . benefits . . . as 'charitable' organizations" under the Code. They also were alleged to be among the intended beneficiaries of the Code sections that grant favorable tax treatment to "charitable" organizations.

Plaintiffs made two principal claims. The first was that in issuing Rev. Rul. 69-545 the defendants had violated the Code, and that in granting charitable-corporation treatment to nonprofit hospitals that refused fully to serve indigents the defendants continued the violation. Their theory was that legislative history of the Code, regulations of the IRS, and judicial precedent had established the term *charitable* in the Code to mean "relief of the poor," and that the challenged Ruling and current practice of the IRS departed from that interpretation. Plaintiffs' second claim was that the issuance of Rev. Rul. 69-545 without a public hearing and an opportunity for submission of views had violated the rulemaking procedures of the APA, 5 U.S.C. § 553. The theory of this claim was that the Ruling should be considered a "substantive" rule as opposed to the "interpretative" type of rule that is exempted from the requirements of § 553.[9] Plaintiffs sought various forms of declaratory and injunctive relief.[10]

By a motion to dismiss, defendants challenged plaintiffs' standing, suggested the nonjusticiability of the subject matter of the suit, and asserted that in any event the action was barred by the Anti-Injunction Act,[11] the tax limitation in the Declaratory Judgment Act,[12] and the doctrine of sovereign immunity. The District Court denied this motion without opinion. On subsequent cross-motions for summary judgment the court considered but rejected each of defendants' arguments against its reaching the merits. The court then held that Rev. Rul. 69-545 was "improperly promulgated" and "without effect" insofar as it permitted nonprofit hospitals to qualify for tax treatment as charities without their offering "special financial consideration to indigents." 370 F. Supp. 325.[13]

The Court of Appeals for the District of Columbia Circuit reversed. 506 F.2d 1278. It agreed with the District Court's rejection of defendants' jurisdictional contentions, but held on the merits that Rev. Rul. 69-545 was founded upon a permissible definition of "charitable" and was not contrary to congressional intent in the Code. As to the plaintiffs' APA claim, which the District Court had not reached, the Court of Appeals held that Rev. Rul. 69-545 was an "interpretative" ruling and thus exempt from the APA's rulemaking requirements.

Plaintiffs sought a writ of certiorari in No. 74-1110 to review the Court of Appeals' judgment on the merits. Defendants filed a cross-petition in No. 74-1124 seeking review of that court's decision on the jurisdictional issues if plaintiffs' petition should be granted. We granted both petitions and consolidated them. 421 U.S. 975. Since we deal with defendants' contentions in No. 74-1124 first, and find it unnecessary to reach the issues raised by plaintiffs in No. 74-1110, we shall refer to defendants below as petitioners and to plaintiffs below as respondents.

III

In this Court petitioners have argued that a policy of the IRS to tax or not to tax certain individuals or organizations, whether embodied in a Revenue Ruling or otherwise developed, cannot be challenged by third parties whose own tax liabilities are not affected. Their theory is that the entire history of this country's revenue

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[9] Section 553(b) states that "[e]xcept when notice and hearing is required by statute, this subsection does not apply—(A) to interpretative rules. . . ."

Plaintiffs also claimed that issuance of Revenue Ruling 69-545 amounted to an abuse of discretion and denied them due process of law. These claims were treated summarily or not at all by the courts below, and plaintiffs have not pressed them in this Court.

[10] Plaintiffs requested judicial declarations that defendants had violated the Code and the APA, and that a hospital's charitable status required provision of full services to persons unable to pay and those on Medicaid. In addition, they sought to enjoin defendants to suspend charitable organization treatment of and to refrain from extending such treatment to, any hospital that failed to submit proof, on forms to be approved by the District Court, that it served indigents and those on Medicaid without either requiring advance deposits or attempting to collect once service had been rendered. Plaintiffs also asked the District Court to order collection of all taxes "due and owing" because of the allegedly "illegal" extension of charitable status to hospitals that refused to serve indigents.

[11] ". . . [N]o suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed." 26 U.S.C. § 7421(a).

[12] "In a case of actual controversy within its jurisdiction, *except with respect to federal taxes*, any court of the United States, upon the filing of an appropriate pleading, may declare the rights and other legal relations of any interested party seeking such declaration, whether or not further relief is or could be sought." 28 U.S.C. § 2201 (emphasis added).

[13] The court entered a declaratory judgment to that effect and enjoined defendants from extending tax-exempt status to a nonprofit hospital, or allowing deductions for contributions to it, until the hospital had satisfied the requirements of previous Revenue Ruling 56-185 regarding service to indigents and had posted in its public areas a court-approved notice reciting those requirements.

system, including but not limited to the evolution of the Internal Revenue Code, manifests a consistent congressional intent to vest exclusive authority for the administration of the tax laws in the Secretary and his duly authorized delegates, subject to oversight by the appropriate committees of Congress itself. It is argued that allowing third-party suits questioning the tax treatment accorded other taxpayers would transfer determination of general revenue policy away from those to whom Congress has entrusted it and to the federal courts.[14]

In addition, petitioners analogize the discretion vested in the IRS with respect to administration of the tax laws to the discretion of a public prosecutor as to when and whom to prosecute. They thus invoke the settled doctrine that the exercise of prosecutorial discretion cannot be challenged by one who is himself neither prosecuted nor threatened with prosecution. See *Linda R. S.* v. *Richard D.*, 410 U.S. 614, 619 (1973). Petitioners also renew their jurisdictional contentions that this action is barred by the Anti-Injunction Act, the Declaratory Judgment Act, and the doctrine of sovereign immunity.

We do not reach either the question of whether a third party ever may challenge IRS treatment of another, or the question of whether there is a statutory or immunity bar to this suit. We conclude that the District Court should have granted petitioners' motion to dismiss on the ground that respondents' complaint failed to establish their standing to sue.[15]

IV

No principle is more fundamental to the judiciary's proper role in our system of government than the constitutional limitation of federal court jurisdiction to actual cases or controversies. See *Flast* v. *Cohen*, 392 U.S. 83, 95 (1968). The concept of standing is part of this limitation. Unlike other associated doctrines, for example that which restrains federal courts from deciding political questions, standing "focuses on the party seeking to get his complaint before a federal court and not on the issues he wishes to have adjudicated." *Id.*, at 99. As we reiterated last Term, the standing question in its Art. III aspect "is whether the plaintiff has 'alleged such a personal stake in the outcome of the controversy' to warrant *his* invocation of federal court jurisdiction and to justify exercise of the court's remedial powers on his behalf." *Warth* v. *Seldin*, 442 U.S. 490, 498-499 (1975) (emphasis in original). In sum, when a plaintiff's standing is brought into issue the relevant inquiry is whether, assuming justiciability of the claim, the plaintiff has shown an injury to himself that is likely to be redressed by a favorable decision. Absent such a showing, exercise of its power by a federal court would be gratuitous and thus inconsistent with the Art. III limitation.[16]

Respondents brought this action under § 10 of the APA, 5 U.S.C. § 702, which gives a right to judicial review to any person "adversely affected or aggrieved by agency action within the meaning of a relevant statute." [17] In *Data Processing Service* v. *Camp*, 397 U.S. 150 (1969), this Court held the constitutional standing requirement under this section to be allegations which, if true, would establish that the plaintiff had been injured in fact by the action he sought to have reviewed. Reduction of the threshold requirement to actual injury redressable by the court represented a substantial broadening of access to the federal courts over that previously thought to be the constitutional minimum under this statute.[18] But as this Court emphasized in *Sierra Club* v. *Morton*, 405 U.S. 727, 738 (1972), "broadening the categories of injury that may be alleged in support of standing is a different matter from abandoning the requirement that the party seeking review must himself have suffered an injury." See also *United States* v. *Richardson*, 418 U.S. 166, 194 (1974) (POWELL, J., concurring). The necessity that the plaintiff who seeks to invoke judicial power stand to profit in some personal interest remains an Art. III requirement. A federal court cannot ignore this requirement without overstepping its assigned role in our system of adjudicating only actual cases and controversies.[19] It is according to this settled

[14] Petitioners rely in part upon this Court's decision in *Louisiana* v. *McAdoo*, 234 U.S. 627 (1914), as precedent for their position. In that case the State of Louisiana, as a producer of sugar, brought suit challenging the tariff rates applied by the Secretary of the Treasury to sugar imported from Cuba. This Court ordered the suit dismissed. Petitioners rely particularly upon statements in the opinion that maintenance of such actions "would operate to disturb the whole revenue system of the Government," and that "[i]nterference [by the courts] in such a case would be to interfere with the ordinary functions of government." 234 U.S., at 632, 633. In view of our disposition, we express no opinion on the application of *McAdoo* to this kind of case.

[15] As noted, *supra*, at 7-8, the District Court considered petitioners' jurisdictional arguments, including their challenge to respondents' standing, when it ruled on cross-motions for summary judgment. The affidavits submitted by respondents merely supported the allegations of the complaint relative to establishing standing, rather than going beyond them. Thus, the standing analysis is no different, as a result of the case having proceeded to summary judgment, than it would have been at the pleading stage. Cf. *Warth* v. *Seldin*, 422 U.S. 490, 501, 502 (1975).

[16] This Court often has noted that the focus upon the plaintiff's stake in the outcome of the issue he seeks to have adjudicated serves a separate and equally important function bearing upon the nature of the judicial process. As stated in *Baker* v. *Carr*, 369 U.S. 186, 204 (1962), a significant personal stake serves "to assure that concrete adverseness which sharpens the presentation of issues upon which the court so largely depends for illumination of difficult . . . questions."

[17] "A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof." 5 U.S.C. § 702.

[18] The previous view can be found in *Kansas City Power & Light Co.* v. *McKay*, 96 U.S. App. D.C. 273, 281, 225 F.2d 924, 932 (1955). See *Sierra Club* v. *Morton*, 405 U.S. 727, 733 (1972).

[19] The *Data Processing* decision established a second, nonconstitutional standing requirement that the interest of the plaintiff, regardless of its nature in the absolute, at least be "arguably within the zone of interests to be protected or regulated" by the statutory framework within which his claim arises. See 397 U.S., at 153. As

principle that the allegations of both the individual respondents and the respondent organizations must be tested for sufficiency.

A

We note at the outset that the five respondent organizations, which described themselves as dedicated to promoting access of the poor to health services, could not establish their standing simply on the basis of that goal. Our decisions make clear that an organization's abstract concern with a subject that could be affected by an adjudication does not substitute for the concrete injury required by Art. III. *Sierra Club* v. *Morton, supra;* see *Warth* v. *Seldin, supra.* Insofar as these organizations seek standing based on their special interest in the health problems of the poor their complaint must fail. Since they allege no injury to themselves as organizations, and indeed could not in the context of this suit, they can establish standing only as representatives of those of their members who have been injured in fact, and thus could have brought suit in their own right. *Warth* v. *Seldin, supra,* at 511. The standing question in this suit therefore turns upon whether any individual respondent has established an actual injury,[20] or whether the respondent organizations have established actual injury to any of their indigent members.

B

The obvious interest of all respondents, to which they claim actual injury, is that of access to hospital services. In one sense, of course, they have suffered injury to that interest. The complaint alleges specific occasions on which each of the individual respondents sought but was denied hospital services solely due to his indigency,[21] and in at least some of the cases it is clear that the needed treatment was unavailable, as a practical matter, anywhere else. The complaint also alleges that members of the respondent organizations need hospital services but live in communities in which the private hospitals do not serve indigents. We thus assume, for purpose of analysis, that some members have been denied service. But injury at the hands of a hospital is insufficient by itself to establish a case or controversy in the context of this suit, for no hospital is a defendant. The only defendants are officials of the Department of the Treasury, and the only claims of illegal action respondents desire the courts to adjudicate are charged to those officials. "Although the law of standing has been greatly changed in [recent] years, we have steadfastly adhered to the requirement that, at least in the absence of a statute expressly conferring standing, federal plaintiffs must allege some threatened or actual injury resulting from the putatively illegal action before a federal court may assume jurisdiction." *Linda, R. S.* v. *Richard D.*, 410 U.S., at 617.[22] In other words, the "case or controversy" limitation of Art. III still requires that a federal court act only to redress injury that fairly can be traced to the challenged action of the defendant, and not injury that results from the independent action of some third party not before the court.

The complaint here alleges only that petitioners, by the adoption of Revenue Ruling 69-545, had "encouraged" hospitals to deny services to indigents.[23] The implicit corollary of this allegation is that a grant of respondents' requested relief, resulting in a requirement that all hospitals serve indigents as a condition to favorable tax treatment, would "discourage" hospitals from denying their services to respondents. But it does not follow from the allegation and its corollary that the denial of access to hospital services in fact results from petitioners' new Ruling, or that a court-ordered return by petitioners to their previous policy would result in these respondents' receiving the hospital services they desire. It is purely speculative whether the denials of service specified in the complaint fairly can be traced to petitioners' "encouragement" or instead

noted earlier, respondents in this case claim that they, and of course their particular interests involved in this suit, are the intended beneficiaries of the charitable organization provisions of the Code. In view of our disposition of this case we need not consider this "zone of interests" test.

[20] The individual respondents sought to maintain this suit as a class action on behalf of all persons similarly situated. That a suit may be a class action, however, adds nothing to the question of standing, for even named plaintiffs who represent a class "must allege and show that they personally have been injured, not that injury has been suffered by other, unidentified members of the class to which they belong and which they purport to represent." *Warth* v. *Seldin,* 422 U. S., at 502.

[21] One of the individual respondents complains not that he was denied service, but that he was treated and then billed despite the hospital's knowledge of his indigency. This variation of the injury does not change the standing analysis.

[22] The reference in *Linda R. S.* to "a statute expressly conferring standing" was in recognition of Congress' power to create new interests the invasion of which will confer standing. See 410 U.S., at 617 n. 3; *Trafficante* v. *Metropolitan Life Ins. Co.*, 409 U.S. 205 (1972). When Congress has so acted, the requirements of Art. III remain: "the plaintiff still must allege a distinct and palpable injury to himself, even if it is an injury shared by a large class of other possible litigants." *Warth* v. *Seldin, supra,* at 501. See also *United States* v. *SCRAP,* 412 U.S. 669 (1973); cf. *Sierra Club* v. *Morton,* 405 U.S., at 732 n. 3.

[23] The Court of Appeals, in sustaining Revenue Ruling 69-545 on the merits, relied in part upon its conclusion that the new IRS policy, which apparently requires a hospital to provide free *emergency* care to indigents, may result in as much or more relief to the poor than the policy of the previous Ruling. Much of respondents' argument, and that of several of the *amici,* has been directed against that conclusion. As we do not reach the merits, we need not consider this question. But we accept for purposes of the standing inquiry respondents' averment that the IRS's new policy encourages a hospital to provide fewer services to indigents than it might have under the previous policy.

We do note, however, that it is entirely speculative whether even the earlier Ruling would have assured the medical care they desire. It required a hospital to provide care for the indigent only "to the extent of its financial ability," and stated that a low charity record was not conclusive that a hospital had failed to meet that duty. See *supra,* at 3. Thus, a hospital could not maintain, consistently with Revenue Ruling 56-185, a general policy of refusing care to all patients unable to pay. But the number of such patients accepted, and whether any particular applicant would be admitted, would depend upon the financial ability of the hospital to which admittance was sought.

result from decisions made by the hospitals without regard to the tax implications.

It is equally speculative whether the desired exercise of the court's remedial powers in this suit would result in the availability to respondents of such services. So far as the complaint sheds light, it is just as plausible that the hospitals to which respondents may apply for service would elect to forego favorable tax treatment to avoid the undetermined financial drain of an increase in the level of uncompensated services. It is true that the individual respondents have alleged, upon information and belief, that the hospitals that denied them service receive substantial donations deductible by the donors. This allegation could support an inference that these hospitals, or some of them, are so financially dependent upon the favorable tax treatment afforded charitable organizations that they would admit respondents if a court required such admission as a condition to receipt of that treatment. But this inference is speculative at best.[24] The Solicitor General states in his brief that, nationwide, private philanthropy accounts for only 4% of private hospital revenues. Respondents introduced in the District Court a statement to Congress by an official of a hospital association describing the importance to nonprofit hospitals of the favorable tax treatment they receive as charitable corporations. Such conflicting evidence supports the common-sense proposition that the dependence upon special tax benefits may vary from hospital to hospital. Thus, respondents' allegation that certain hospitals receive substantial charitable contributions, without more, does not establish the further proposition that those hospitals are dependent upon such contributions.

Prior decisions of this Court establish that unadorned speculation will not suffice to invoke the federal judicial power. In *Linda R. S.* v. *Richard D., supra,* the mother of an illegitimate child averred that state court interpretation of a criminal child support statute as applying only to fathers of legitimate children violated the Equal Protection Clause of the Fourteenth Amendment. She sought an injunction requiring the district attorney to enforce the statute against the father of her child. We held that the mother lacked standing, because she had "made no showing that her failure to secure support payments results from the nonenforcement, as to her child's father, of [statute]." *Id.,* at 618. The prospect that the requested prosecution in fact would result in the payment of child support—instead of jailing the father—was "only speculative." *Ibid.* Similarly, last Term in *Warth* v. *Seldin, supra,* we held that low-income persons seeking the invalidation of a town's restrictive zoning ordinance lacked standing because they had failed to show that the alleged injury, inability to obtain adequate housing within their means, was fairly attributable to the challenged ordinance instead of to other factors. In language directly applicable to this case, we there noted that plaintiffs relied "on little more than the remote possibility, unsubstantiated by allegations of fact, that their situation might have been better had [defendants] acted otherwise, and might improve were the court to afford relief." *Id.,* at 507.

The principle of *Linda R. S.* and *Warth* controls this case. As stated in *Warth,* that principle is that indirectness of injury, while not necessarily fatal to standing, "may make it substantially more difficult to meet the minimum requirement of Art. III: to establish that, in fact, the asserted injury was the consequence of the defendants' actions, or that prospective relief will remove the harm." 422 U.S., at 505. Respondents have failed to carry this burden. Speculative inferences are necessary to connect their injury to the challenged actions of petitioners.[25] Moreover, the complaint suggests no substantial likelihood that victory in this suit would result in respondents' receiving the hospital treatment they desire. A federal court, properly cognizant of the Art. III limitation upon its jurisdiction, must require more than respondents have shown before proceeding to the merits.

Accordingly, the judgment of the Court of appeals is vacated and the cause is remanded to the District Court with instructions to dismiss the complaint.

It is so ordered.

MR. JUSTICE STEVENS took no part in the consideration or decision of these cases.

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[24] The complaint reveals nothing at all about the dependence upon charitable contributions of any hospitals that might have denied services to members of respondent organizations.

[25] The courts below erroneously believed that *United States* v. *SCRAP,* 412 U.S. 669 (1973), supported respondents' standing. In *SCRAP,* although the injury was indirect and "the Court was asked to follow [an] attenuated line of causation," *id.,* at 688, the complaint nevertheless "alleged a specific and perceptible harm" flowing from the agency action. *Id.,* at 689. Such a complaint withstood a motion to dismiss, although it might not have survived challenge on a motion for summary judgment. *Id.,* and n. 15. But in this case the complaint is insufficient even to survive a motion to dismiss, for it fails to allege an injury that fairly can be traced to petitioners' challenged action. Nor did the affidavits before the District Court at the summary judgment stage supply the missing link.

Our decision is also consistent with *Data Processing Service* v. *Camp, supra.* The Court there stated that "[t]he first question is whether the plaintiff alleges that the challenged action has caused him injury in fact, economic or otherwise." 397 U.S., at 152. The complaint in *Data Processing* alleged injury that was directly traceable to the action of the defendant federal official, for it complained of injurious competition that would have been illegal without that action. Accord, *Arnold Tours, Inc.* v. *Camp,* 400 U.S. 45 (1970); *Investment Co. Institute* v. *Camp,* 401 U.S. 617, 620-621 (1971). Similarly, the complaint in *Data Processing's* companion case of *Barlow* v. *Collins,* 397 U.S. 159 (1970), was sufficient because it alleged extortionate demands by plaintiffs' landlord made possible only by the challenged action of the defendant federal official. See *id.,* at 162-163. In the instant case respondent's injuries might have occurred even in the absence of the IRS Ruling that they challenge; whether the injuries fairly can be traced to that Ruling depends upon unalleged and unknown facts about the relevant hospitals.

SUPREME COURT OF THE UNITED STATES

No. 74-958

United States et al.,
Petitioners, v. Max Janis

[428 U.S. 433]

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

(July 6, 1976)

Syllabus

Based upon the affidavit of a police officer, a Los Angeles judge issued a search warrant, pursuant to which the police seized from respondent $4,940 in cash and certain wagering records. The officer advised the Internal Revenue Service (IRS) that respondent had been arrested for bookmaking activity. Using a calculation based upon the seized evidence, the IRS assessed respondent for wagering excise taxes and levied upon the $4,940 in partial satisfaction. In the subsequent state criminal proceeding against respondent the trial court found the police officer's affidavit defective, granted a motion to quash the warrant, and ordered the seized items returned to the respondent, except for the $4,940, Respondent filed a refund claim for the $4,940 and, later, this action. The Government answered and counterclaimed for the unpaid balance of the assessment. Respondent moved to suppress the evidence seized and all copies thereof, and to quash the assessment. The District Court, after a hearing, concluded that respondent was entitled to a refund, because the assessment "was based in substantial part, if not completely, on illegally procured evidence in violation of [respondent's] Fourth Amendment rights," and that under the circumstances respondent was not required to prove the extent of the claimed refund. The assessment was quashed and the counterclaim accordingly was dismissed. The Court of Appeals affirmed. *Held:* The judicially created exclusionary rule should not be extended to forbid the use in the civil proceeding of one sovereign (here the Federal Government) of evidence seized by a criminal law enforcement agent of another sovereign (here the State Government), since the likelihood of deterring law enforcement conduct through such a rule is not sufficient to outweigh the societal costs imposed by the exclusion.

(a) The prime, if not the sole, purpose of the exclusionary rule "is to deter future unlawful police conduct."

(b) Whether the exclusionary rule is a deterrent has not yet been demonstrated. Assuming, however, that it is a deterrent, then its use in situations where it is now applied must be deemed to suffice to accomplish its purpose, because the local law enforcement official is already "punished" by the exclusion of the evidence in both the state and the federal criminal trials. The additional marginal deterrence provided by its extension in cases like this one does not outweigh the societal costs of excluding concededly relevant evidence.
Reversed and remanded.

BLACKMUN, J., delivered the opinion of the Court, in which BURGER, C. J., and WHITE, POWELL, and REHNQUIST, JJ., joined BRENNAN, J., filed a dissenting opinion, in which MARSHALL, J., joined. STEWART, J., filed a dissenting opinion. STEVENS, J., took no part in the consideration or decision of the case.

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

This case presents an issue of the appropriateness of an extension of the judicially created exclusionary rule: is evidence seized by a state criminal law enforcement officer in good faith, but nonetheless unconstitutionally, inadmissible in a civil proceednig by or against the United States?

I

In November 1968 the Los Angeles police obtained a warrant directing a search for bookmaking paraphernalia at two specified apartment locations in the city and, as well, on the respective persons of Morris Aaron Levine and respondent Max Janis. The warrant was issued by a judge of the Municipal Court of the Los Angeles Judicial District. It was based upon the affidavit of Officer Leonard Weissman.[1] After the search, made pursuant to the warrant, both the respondent and Levine were arrested and the police seized from respondent property consisting of $4,940 in cash and certain wagering records.[2]

Soon thereafter, Officer Weissman telephoned an agent of the United States Internal Revenue Service and informed the agent that Janis had been arrested for bookmaking activity.[3] With the assistance of Weissman,

[1] Officer Weissman's affidavit, App. 69-74, stated: He and Sergeant Briggs of the Los Angeles Police Department each had received information from an informant concerning respondent Janis and Levine and concerning telephone numbers the two men used for bookmaking. Police investigation disclosed that Janis had two telephones with unpublished numbers, including the number given by Weissman's informant, and that there was a third published number at the same address in the name of Nancy L. Janis. The unpublished numbers given by Weissman's informant as being used by Levine were found to be maintained by Levine at a different address, and that address was the one given by Briggs' informant as being Levine's base of operations. Both informants stated that Levine and Janis were working in concert. Each officer regarded his informant as reliable; the informant had given information in the past that led to arrests for bookmaking and, in the case of Briggs' informant, to convictions as well. Preliminary hearings and trials were pending for persons arrested with the aid of Weissman's informant. Each officer and his informant believed that it was necessary for the informant's safety, and his future usefulness to law enforcement officers, that his identity be kept secret.

Weissman further stated:

"From the nature and context of the information supplied by the informant to this affiant, and from the nature and context of the information which was supplied to Sgt. Briggs, as told to this affiant, it is believed that the informants . . . at all times mentioned in this affidavit, unless otherwise specified, were speaking with personal knowledge." *Id.*, at 73.

The affidavit, taken in its entirety, bears some similarity to the affidavit the Court later considered in *Spinelli* v. *United States*, 393 U.S. 410, 420-422 (1969). *Spinelli* was a 5-3 decision handed down two months *after* the Los Angeles warrant in the present case had been issued. MR. JUSTICE WHITE joined the opinion in *Spinelli*, *id.*, at 423-429, but, in doing so, referred, *id.*, at 427, to the "tension between *Draper*" v. *United States*, 358 U.S. 307 (1959), on the one hand, and *Nathanson* v. *United States*, 290 U.S. 41 (1933), and *Aguilar* v. *Texas*, 378 U.S. 108 (1964), on the other, and, "[p]ending full-scale reconsideration" of *Draper* "or of the *Nathanson-Aguilar* cases," joined "the opinion of the Court and the judgment of reversal, especially since a vote to affirm would produce an equally divided Court." 393 U.S., at 429.

[2] The Internal Revenue Service's Certificate of Assessments and Payments, App. 81, shows a credit of $5,097, the amount actually seized by the police and subjected to the Service's subsequent levy. The Government acknowledges, however, that $157 of this amount was money belonging to Levine. It was applied upon the joint assessment made against both Janis and Levine. Levine has not sought a refund of the $157. Brief for the United States 5 n. 1. The present case, however, concerns only the $4,940 taken from respondent Janis.

[3] Officer Weissman testified that there was no departmental policy to call the Internal Revenue Service in a situation of this kind. He did it "as a matter of police procedure." He would not do it, he said, on what he "would consider a small-size book, but I considered this one a major-size book. So, I, therefore, did it." App.

who was familiar with bookmakers' codes, the revenue agent analyzed the wagering records that had been seized and determined from them the gross volume of respondent's gambling activity for the five days immediately preceding the seizure. Weissman informed the agent that he had conducted a surveillance of respondent's activities that indicated that respondent had been engaged in bookmaking during the 77-day period from September 14 through November 30, 1968, the day of the arrest.

Respondent had not filed any federal wagering tax return pertaining to bookmaking activities for that 77-day period. Based exclusively upon its examination of the evidence so obtained by the Los Angeles police, the Internal Revenue Service made an assessment jointly against respondent and Levine for wagering taxes, under § 4401 of the Internal Revenue Code of 1954, 26 U. S. C. § 4401, in the amount of $89,026.09, plus interest. The amount of the assessment was computed by first determining respondent's average daily gross proceeds for the five-day period covered by the seized material and analyzed by the agent, and then multiplying the resulting figure by 77, the period of the police surveillance of respondent's activities.[4] The assessment having been made, the Internal Revenue Service exercised its statutory authority, under 26 U. S. C. § 6331, to levy upon the $4,940 in cash in partial satisfaction of the assessment against respondent.

Charges were filed in due course against respondent and Levine in Los Angeles Municipal Court for violation of the local gambling laws. They moved to quash the search warrant. A suppression hearing was held by the same judge who had issued the warrant. The defendants pressed upon the court the case of *Spinelli* v. *United States*, 393 U. S. 410 (1969), which had been decided just three weeks earlier and *after* the search warrant had been issued. They urged that the Weissman affidavit did not set forth, in sufficient detail, the underlying circumstances to enable the issuing magistrate to determine independently the reliability of the information supplied by the informants. The judge granted the motion to quash the warrant. He then ordered that all items seized pursuant to it be returned except the cash that had been levied upon by the Internal Revenue Service. App. 78-80.

In June 1969 respondent filed a claim for refund of the $4,940. The claim was not honored, and 18 months later, in December 1970, respondent filed suit for that amount in the United States District Court for the Central District of California. The Government answered and counterclaimed for the substantial unpaid balance of the assessment.[5] In pretrial proceedings, it was agreed that the "sole basis of the computation of the civil tax assessment . . . was . . . the items obtained pursuant to the search warrant . . . and the information furnished to [the revenue agent] by Officer Weissman with respect to the duration of [respondent's] alleged wagering activities." [6] App. 18. Respondent then moved to suppress the evidence seized, and all copies thereof in the possession of the Service, and to quash the assessment. App. 23-24.

At the outset of the hearing on the motion, the District Court observed that it was "reluctantly holding that the affidavit supporting the search warrant is insufficient under the *Spinelli* and *Aguilar* [v. *Texas*, 378 U. S. 108 (1964)] doctrines." App. 47. It then concluded that "[a]ll of the evidence utilized as the basis" of the assessment "was obtained directly or indirectly as a result of the search pursuant to the defective search warrant," and that, consequently, the assessment "was based in substantial part, if not completely, on illegally procured evidence . . . in violation of [respondent's] Fourth Amendment rights to be free from unreasonable searches and seizures." 73-1 USTC ¶ 16,083, p. 81,392 (1973). The court concluded that Janis was entitled to a refund of the $4,940, together with interest thereon, "for the reason that substantially all, if not all, of the evidence utilized by the defendants herein in making their assessment . . . was illegally obtained, and, as such, the assessment was invalid." *Ibid.* Further, where, as here, "illegally obtained evidence constitutes the basis of a federal tax assessment," the respondent was "not required to prove the extent of the refund to which he claims he is entitled." *Id.*, at 81,393. Instead, it was sufficient if he prove "that substantially all, if not all, of the evidence upon which the assessment was based was the result of illegally obtained evidence." Accordingly, the court ordered that the civil tax assessment made by the Internal Revenue Service "against all the property and assets of . . . Janis be quashed," and entered judgment for the respondent. *Ibid.* The Government's counterclaim was dismissed with prejudice. The United States Court of Appeals for the Ninth Circuit, by unpublished memorandum without opinion, affirmed on the basis of the District Court's findings of fact and conclusions of law. Pet. for Cert. 12A.

Because of the obvious importance

42. He further stated that some of his fellow officers had acted similarly, but that he did not think "that they all have done it." *Ibid.* The District Court did not rest its conclusion on any federal involvement in, or encouragement of, the search. We therefore must assume, for purposes of this opinion, that there was no federal involvement. See n. 31, *infra*.

[4] The wagering excise tax at the time was 10% of the amount of the wagers. § 4401(a) of the Internal Revenue Code of 1954, 26 U.S.C. §4401(a) (1970). The rate was reduced to 2%, effective December 1, 1974, by Pub. L. 93-499 [1974-2 C.B. 456], § 3(a), 88 Stat. 1550 (1974).

[5] The Government advises us that, in order to avoid multiple litigation, it is its policy to counterclaim in a refund suit, just as it did here, where there is an outstanding unpaid assessment and the refund suit and the counterclaim involve the same facts. Brief for the United States 17 n. 4.

[6] The Certificate of Assessments and Payments was stipulated "to be admissible without objection." App. 20. The Government did not seek to introduce the wagering records obtained by the Los Angeles police.

The Government has not asserted that, absent the seized materials, it would have had grounds for an assessment against respondent and Levine.

of the question, we granted certiorari. 421 U. S. 1010 (1975).

II

Some initial observations about the procedural posture of the case in the District Court are indicated. If there is to be no limit to the burden of proof the respondent, as "taxpayer," must carry, then, even though he were to obtain a favorable decision on the inadmissibility-of-evidence issue, the respondent on this record could not possibly defeat the Government's counterclaim. The Government notes, properly we think, that the litigation is composed of two separate elements: the refund suit instituted by the respondent, and the collection suit instituted by the United States through its counterclaim. In a refund suit the taxpayer bears the burden of proving the amount he is entitled to recover. *Lewis* v. *Reynolds,* 284 U. S. 281 (1932) [Ct. D. 443, XI-1 C.B. 131]. It is not enough for him to demonstrate that the assessment of the tax for which refund is sought was erroneous in some respects.

This Court has not spoken with respect to the burden of proof in a tax collection suit. The Government argues here that the presumption of correctness that attaches to the assessment in a refund suit must also apply in a civil collection suit instituted by the United States under the authority granted by §§ 7401 and 7403 of the Code, 26 U. S. C. §§ 7401 and 7403. Thus, it is said, the defendant in a collection suit has the same burden of proving that he paid the correct amount of his tax liability.

The policy behind the presumption of correctness and the burden of proof, see *Bull* v. *United States,* 295 U. S. 247, 259-260 (1935) [Ct. D. 969, XIV-1 C.B. 310], would appear to be applicable in each situation. In accords, furthermore, with the burden-of-proof rule which prevails in the usual preassessment proceeeding in the United States Tax Court. *Lucas* v. *Structural Steel Co.,* 281 U. S. 264, 271 (1930); *Welch* v. *Helvering,* 290 U. S. 111, 115 (1933) [Ct. D. 775, XII-2 C.B. 112]; Rule 142(a) of the Rules of Practice and Procedure of the United States Tax Court (1974). In any event, for purposes of this case, we assume that this is so and that the burden of proof may be said technically to rest with respondent Janis.

Respondent, however, submitted no evidence tending either to demonstrate that the assessment was incorrect or to show the correct amount of wagering tax liability, if any, on his part. In the usual situation one might well argue, as the Government does, that the District Court then could not properly grant judgment for the respondent on either aspect of the suit. But the present case may well not be the usual situation. What we have is a "naked" assessment without *any* foundation whatsoever if what was seized by the Los Angeles police cannot be used in the formulation of the assessment.[7] The determination of tax due then may be one, "without rational foundation and excessive," and not properly subject to the usual rule with respect to the burden of proof in tax cases. *Helvering* v. *Taylor,* 293 U. S. 507, 514-515 (1935) [Ct. D. 912, XIV-1 C.B. 168].[8] See 9 J. Mertens, Law of Federal Income Taxation ¶ 50.65 (1971).

There appears, indeed to be some debate among the federal courts of appeals, in different factual contexts, as to the effect upon the burden of proof in a tax case when there is positive evidence that an assessment is incorrect. Some courts indicate that the burden of showing the amount of the deficiency then shifts to the Commissioner.[9] Others hold that the burden of showing the correct amount of the tax remains with the taxpayer.[10] However that may be, the debate does not extend to the situation where the assessment is shown to be naked and without *any* foundation. The courts then appear to apply the rule of the *Taylor* case. See *United States* v. *Rexach,* 482 F. 2d 10, 16-17, n. 3 (CA1), cert. denied, 414 U. S. 1039 (1973); *Pizzarello* v. *United States,* 408 F. 2d 579 (CA2), cert. denied, 396 U. S. 986 (1969); *Suarez* v. *Commissioner,* 58 T. C. 814-815 (1972). But cf. *Compton* v. *United States,* 334 F. 2d 212, 216 (CA4 1964).

Certainly, proof that an assessment is utterly without foundation is proof that it is arbitrary and erroneous. For purposes of this case, we need not go so far as to accept the Government's argument that the exclusion of the evidence in issue here is insufficient to require judgment for the respondent or even to shift the burden to the Government. We are willing to assume that if the District Court was correct in ruling that the evidence seized by the Los Angeles police may not be used in formulating the assessment (on which both the levy and the counterclaim were based), then the District Court was also correct in granting judgment for Janis in both aspects of the present suit. This assumption takes us, then, to the primary issue.[11]

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[7] The situation may be described as having some resemblance to that for which the Court has developed an exception to the Anti-Injunction Act, § 7421(a) of the Code, 26 U.S. § 7421(a). See *Enochs* v. *Williams Packing & Navigation Co.,* 370 U.S. 1 (1962) [Ct. D 1874, 1962-2 C.B. 349]; *Bob Jones University* v. *Simon,* 416 U.S. 725 (1974) [Ct. D. 1962, 1974-1 C.B. 354]; *Commissioner* v. *"Americans United" Inc.,* 416 U.S. 752 (1974) [Ct. D. 1963, 1974-1 C.B. 7]; *Laing* v. *United States,* 423 U.S. 161 (1976) [Ct. D. 1973, 1976-7 I.R.B. 16]; *Commissioner* v. *Shapiro,* 424 U.S.—(1976) [Ct. D. 1974, 1976-15 I.R.B. 22].

[8] Taylor, although decided more than 40 years ago, has never been cited by this Court on the burden of proof issue. The courts of appeals, the Court of Claims, the Tax Court, and the federal district courts, however, frequently have referred to that aspect of the case.

[9] *E.g., Foster* v. *Commissioner,* 391 F. 2d 727, 735 (CA4 1968); *Herbert* v. *Commissioner,* 377 F. 2d 65, 69 (CA9 1967). See *Bar L Ranch, Inc.* v. *Phinney,* 426 F. 2d 995, 999 (CA5 1970).

[10] *E.g., United States* v. *Rexach,* 482 F. 2d 10, 15-17 (CA1), cert. denied, 414 U.S. 1039 (1973); *Psaty* v. *United States,* 442 F. 2d 1154, 1158-1161 (CA3 1971); *Ehlers* v. *Vinal,* 382 F. 2d 58, 65-66 (CA8 1967). See *Bar L Ranch, Inc.* v. *Phinney,* 426 F. 2d, at 998.

[11] Although the present case presents only the issue whether such evidence may be used in the formulation of the assessment, there appears to be no difference between that question and the issue whether the evidence is to be excluded in the refund or collection suit itself. We per-

III

This Court early pronounced a rule that the Fifth Amendment's command that no person "shall be compelled in any criminal case to be a witness against himself" renders evidence falling within the Amendment's prohibition inadmissible. *Boyd* v. *United States,* 116 U. S. 616 (1886). It was not until 1914, however, that the Court held that the Fourth Amendment alone may be the basis for excluding from a federal criminal trial evidence seized by a federal officer in violation solely of that Amendment. *Weeks* v. *United States,* 232 U. S. 383 (1914). This comparatively late judicial creation of a Fourth Amendment exclusionary rule is not particularly surprising. In contrast to the Fifth Amendment's direct command against the admission of compelled testimony, the issue of admissibility of evidence obtained in violation of the Fourth Amendment is determined after, and apart from, the violation.[12] In *Weeks* it was held, however, that the Fourth Amendment did not apply to state officers, and, therefore, that material seized unconstitutionally by a state officer could be admitted in a federal criminal proceeding. This was the "silver platter" doctrine.[13]

In *Wolf* v. *Colorado,* 338 U. S. 25 (1949), the Court determined that the Due Process Clause of the Fourteenth Amendment reflected the Fourth Amendment to the extent of providing those protections against intrusions that are "implicit in the concept of ordered liberty.' " *Id.,* at 27. Nonetheless, the Court, in not applying the *Weeks* doctrine in a state trial to the product of a state search, held:

> "Granting that in practice the exclusion of evidence may be an effective way of deterring unreasonable searches, it is not for this Court to condemn as falling below the minimal standards assured by the Due Process Clause a State's reliance upon other methods which, if consistently enforced, would be equally effective." *Id.,* at 31.

Not long thereafter, the Court ruled that means used by a State to procure evidence could be sufficiently offensive to the concept of ordered liberty as to make admission of the evidence so procured a violation of the Due Process Clause, *Rochin* v. *California,* 342 U. S. 165 (1952), but that such a violation would exist only in the most extreme case, *Irvine v. California,* 347 U. S. 128 (1954).

Thus, as matters then stood, the Fourth Amendment was applicable to the States, but a State could allow its official to engage in a violation thereof with no judicial sanction except in the most extreme case. In addition, federal authorities, if they happened upon a State so inclined, could profit from the State's action by receiving on a silver platter evidence unconstitutionally obtained. The federal authorities, profiting thereby, had no judicially created reason to discourage unconstitutional searches by a State, and the States, having no judicially mandated controls, were free to engage in such searches.[14]

Elkins v. *United States,* 364 U. S. 206, was decided in 1960. Invoking its "supervisory power over the administration of criminal justice in the federal courts," *id.,* at 216, the Court held

> "that evidence obtained by state officers during a search which, if conducted by federal officers, would have violated the defendant's immunity from unreasonable searches and seizures under the Fourth Amendment is inadmissible over the defendant's timely objection in a federal criminal trial." *Id.,* at 223.

The rule thus announced apparently served two purposes. First, it assured that a State, which could admit the evidence in its own proceedings if it so chose, nevertheless would suffer some deterrence in that its federal counterparts would be unable to use the evidence in federal criminal proceedings. Second, the rule discouraged federal authorities from using a state official to circumvent the restrictions of *Weeks.*

Only one year later however, the exclusionary rule was made applicable to state criminal trials. *Mapp* v. *Ohio,* 367 U. S. 643 (1961). The Court ruled:

> "Since the Fourth Amendment's right of privacy has been declared enforceable against the States through the Due Process Clause of the Fourteenth, it is enforceable against them by the same sanction of exclusion as is used against the Federal Government." *Id.,* at 655.

The debate within the Court on the exclusionary rule has always been a warm one.[15] It has been unaided, un-

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ceive no principled distinction to be made between the use of the evidence as the basis of an assessment and its use in the case-in-chief.

[12] "[T]he ruptured privacy of the victims' homes and effects cannot be restored. Reparation comes too late." *Linkletter* v. *Walker,* 381 U.S. 618, 637 (1965). "The rule is calculated to prevent, not to repair. Its purpose is to deter—to compel respect for the constitutional guaranty in the only effectively available way—by removing the incentive to disregard it." *Elkins* v. *United States,* 364 U.S. 206, 217 (1960). See *United States* v. *Calandra,* 414 U.S. 338, 347-348 (1974); *Mapp* v. *Ohio,* 367 U.S. 643, 656 (1961); *Tehan* v. *Shott,* 382 U.S. 406, 413 (1966); *Terry* v. *Ohio,* 392 U.S. 1, 29 (1968).

[13] In *Elkins* v. *United States,* 364 U.S. 206, 208 n. 1 (1960), the Court noted that the appellation stems from Mr. Justice Frankfurter's plurality opinion in *Lustig* v. *United States,* 338 U.S. 74 (1949):

"The crux of that doctrine is that a search is a search by a federal official if he had a hand in it; it is not a search by a federal official if evidence secured by state authorities is turned over to the federal authorities on a silver platter." *Id.,* at 78-79.

[14] The absence of this Court's imposition of controls did not mean, of course, that the States were running unchecked in their pursuit of evidence. Not only were there tort remedies and internal disciplinary sanctions available, but, as the Court noted in *Elkins:*

"Not more than half the states continue totally to adhere to the rule that evidence is freely admissible no matter how it was obtained. Most of the others have adopted the exclusionary rule in its entirety; the rest have adopted it in part." 364 U.S., at 219 (footnote omitted), and Appendix, at 224-225.

[15] Except for the unanimous decision written by Mr. Justice Day in *Weeks* v. *United States,* 232 U.S. 383 (1914), the evolution of the exclusionary rule has been marked by sharp divisions in the Court. Indeed, *Wolf, Lustig, Rochin, Irvine, Elkins, Mapp,* and *Calandra* produced a combined total of 27 separate signed opinions or statements.

happily, by any convincing empirical evidence on the effects of the rule. The Court, however, has established that the "prime purpose" of the rule, if not the sole one, "is to deter future unlawful police conduct." *United States* v. *Calendra,* 414 U.S. 383, 347 (1974). See *United States* v. *Peltier,* 422 U. S. 351, 536-539 (1975). Thus

> "[i]n sum, the rule is a judicially created remedy designed to safeguard Fourth Amendment rights generally through its deterrent effect, rather than a personal constitutional right of the party aggrieved." *United States* v. *Calandra,* 414 U. S., at 348.

And

> "[a]s with any remedial device, the application of the rule has been restricted to those areas where its remedial objectives are thought most efficaciously served." *Ibid.*[16]

In the complex and turbulent history of the rule, the Court never has applied it to exclude evidence from a civil proceeding, federal or state.[17]

IV

In the present case we are asked to create judicially a deterrent sanction by holding that evidence obtained by a state criminal law enforcement officer in good-faith reliance on a warrant that later proved to be defective shall be inadmissible in a federal civil tax proceeding. Clearly, the enforcement of admittedly valid laws would be hampered by so extending the exclusionary rule, and, as is nearly always the case with the rule, concededly relevant and reliable evidence would be rendered unavailable.[18]

In evaluating the need for a deterrent sanction, one must first identify those who are to be deterred. In this case it is the state officer who is the primary object of the sanction. It is his conduct that is to be controlled. Two factors suggest that a sanction in addition to those that presently exist is unnecessary. First, the local law enforcement official is already "punished" by the exclusion of the evidence in the state criminal trial.[19] That, necessarily, is of substantial concern to him. Second, the evidence is also excludable in the federal criminal trial, *Elkins* v. *United States, supra,* so that the entire criminal enforcement process, which is the concern and duty of these officers, is frustrated.[20]

Jurists and scholars uniformly have recognized that the exclusionary rule imposes a substantial cost on the societal interest in law enforcement by its proscription of what concededly is relevant evidence. See, *e. g., Bivens* v *Six Unknown Fed. Narcotics Agents,* 403 U. S. 388, 411 (1971) (BURGER, C. J., dissenting); A. Amsterdam, Perspectives on the Fourth Amendment, 58 Minn. L. Rev. 349, 429 (1974). And alternatives that would be less costly to societal interests have been the subject of extensive discussion and exploration.[21]

Equally important, although scholars have attempted to determine whether the exclusionary rule in fact does have any deterrent effect, each empirical study on the subject, in its

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[16] Thus, the Court has held that the exclusionary rule may be invoked only by those whose rights are infringed by the search itself, and not by those who are merely aggrieved by the introduction of evidence so obtained. *Alderman* v. *United States,* 394 U.S. 165, 174-175 (1969).

[17] The Court has applied the exclusionary rule in a proceeding for forfeiture of an article used in violation of the criminal law. *One 1958 Plymouth Sedan* v. *Pennsylvania,* 380 U.S. 693 (1965). There it expressly relied on the fact that "forfeiture is clearly a penalty for the criminal offense" and "[i]t would be anomalous indeed, under these circumstances, to hold that in the criminal proceeding the illegally seized evidence in excludable, while in the forfeiture proceeding, requiring the determination that the criminal law has been violated, the same evidence would be admissible." *Id.,* at 701. See also *Boyd* v. *United States,* 116 U.S. 616, 634 (1886), where a forfeiture proceeding was characterized as "quasi-criminal."

[18] There are studies and commentary to the effect that the exclusionary rule tends to lessen the accuracy of the evidence presented in court because it encourages the police to lie in order to avoid suppression of evidence. See, *e.g.,* Garbus, Police Perjury, 8 Crim. L. Bull. 363 (1972); Kuh, The *Mapp* Case One Year After; An Appraisal of its Impact in New York, 148 N. Y. L. J. Nos. 55 and 56 (Sept. 1962); Comment, Police Perjury in Narcotics "Dropsy" Cases: A New Credibility Gap, 60 Geo. L. J. 507 (1971); Comment, Effect of *Mapp* v. *Ohio* on Police Search-and-Seizure Practices in Narcotics Cases, 4 Col. J. L. & Soc. Probs. 87 (1968]. See also *People* v. *McMurty,* 64 Misc. 2d 314 N. Y. S. 2d 194 (N. Y. C. Crim. Ct. 1970).

[19] It is of interest to note that the exclusion of this evidence from the California state trial was required by a decision of the State's Supreme Court issued some years prior to *Mapp.* See *People* v. *Cahan,* 44 Cal. 2d 434, 282 P. 2d 905 (1955).

[20] We are aware of the suggestion, made by some commentators and incorporated in some studies, that police often view trial and conviction as a lesser aspect of law enforcement. See, *e.g.,* J. Skolnick, Justice Without Trial 219-235 (2d ed., 1975); Milner, Supreme Court Effectiveness and the Police Organization, 36 Law & Contemp. Probs. 467, 475, 479 (1971); Oaks, Studying the Exclusionary Rule in Search and Seizure, 37 U. Chi. L. Rev. 665, 720-736 (1970).

[21] See, *e.g., Bivens* v. *Six Unknown Fed. Named Agents,* 403 U.S. 388, 411 (1971) (BURGER, C. J., dissenting); A. L. I. Model Code of Pre-Arraignment Procedure § 290.2 (Proposed Official Draft, 1975); Davidow, Criminal Procedure Ombudsman as a Substitute for the Exclusionary Rule: A Proposal, 4 Tex. Tech. L. Rev. 317 (1973); Davis, An Approach to Legal Control of the Police, 52 Tex. L. Rev. 703 (1973); Foote, Tort Remedies for Police Violations of Individual Rights, 39 Minn. L. Rev. 493 (1955); Geller, Enforcing the Fourth Amendment: The Exclusionary Rule and Its Alternatives, 1975 Wash. U. L. Q. 621; Kaplan, The Limits of the Exclusionary Rule, 26 Stan. L. Rev. 1027 (1974); LaFave, Improving Police Performance Through the Exclusionary Rule —Part II: Defining the Norms and Training the Police, 30 Mo. L. Rev. 566 (1965); McGowan, Rule-Making and the Police, 70 Mich. L. Rev. 659 (1972); Quinn, The Effect of Police Rulemaking on the Scope of the Fourth Amendment Rights, 52 J. Urb. L. 25 (1974); Roche, A Viable Substitute for the Exclusionary Rule: A Civil Rights Appeals Board, 30 Wash. & Lee L. Rev. 223 (1973); Spiotto, The Search and Seizure Problem—Two Approaches: The Canadian Tort Remedy and the U.S. Exclusionary Rule, 1 J. Police Sci. & Ad. 36 (1973); Spiotto, Search and Seizure: An Empirical Study of the Exclusionary Rule and Its Alternatives, 2 J. Leg. Stud. 243 (1973); Comment, Federal Injunctive Relief from Illegal Search, 1967 Wash. U. L. Q. 104; Comment, The Federal Injunction as a Remedy for Unconstitutional Police Conduct, 78 Yale L. J. 143 (1968); Comment, Use of § 1983 to Remedy Unconstitutional Police Conduct: Guarding the Guards, 5 Harv. Civ. Rights-Civ. Lib. L. Rev. 104 (1970).

own way, appears to be flawed.[22] It would not be appropriate to fault those who have attempted empirical studies for their lack of convincing data. The number of variables is substantial,[23] and many cannot be measured or subjected to effective controls. Recordkeeping before *Mapp* was spotty at best, and thus severely hampers before-and-after studies. Since *Mapp*, of course, all possibility of broad-scale controlled or even semi-controlled comparison studies has been eliminated.[24] "Response" studies are hampered by the presence of the respondents' interests.[25] And extrapolation studies are rendered highly inconclusive by the changes in legal doctrines and police-citizen relationships that have taken place in the 15 years since *Mapp* was decided.[26]

We find ourselves, therefore, in no better position than the Court was in 1960 when it said:

[22] The salient and most comprehensive study is that of Oaks, cited above in n. 21. Professor (now President) Oaks reviews at length the data in previous studies and the problems involved in drawing conclusions from that data. The previous studies include, *inter alia*, D. Oaks & W. Lehman, A Criminal Justice System and the Indigent: A Study of Chicago and Cook County (1968); J. Skolnick, Justice Without Trial (1st ed. 1966); Goldstein, Police Discretion not to Invoke the Criminal Process: Low-Visibility Decisions in the Administration of Justice, 69 Yale L. J. 543 (1960); Kamisar, On the Tactics of Police-Prosecution Oriented Critics of the Courts, 49 Cornell L. Q. 436 (1964); Kamisar, Public Safety v. Individual Liberties: Some "Facts" and "Theories," 53 J. Crim. L. C. & P. S. 171 (1962); Kamisar, Wolf & Lustig, Ten Years Later: Illegal State Evidence in State and Federal Courts, 43 Minn. L. Rev. 1083 (1959); Katz, The Supreme Court and the States: An Inquiry into *Mapp* v. *Ohio* in North Carolina. The Model, the Study and the Implications, 45 N. C. L. Rev. 119 (1966); Kuh, *supra;* Nagel, Testing the Effects of Excluding Illegally Seized Evidence, 1965 Wis. L. Rev. 283; Paulsen, The Exclusionary Rule and Misconduct by the Police, 52 J. Crim. L. C. & P. S. 255 (1961); Comment, Search and Seizure in Illinois: Enforcement of the Constitutional Right of Privacy, 47 Nw. U. L. Rev. 493 (1952); Weinstein, Local Responsibility for Improvement of Search and Seizure Practices, 34 Rocky Mt. L. Rev. 150 (1962); Younger, Constitutional Protection on Search and Seizure Dead?, 3 Trial 41 (Aug.-Sept. 1967); Comment, Effect of *Mapp* v. *Ohio* on Police Search-and-Seizure Practices in Narcotics Cases, 4 Colum. J. L. & Soc. Prob. 87 (1968).

Oaks discusses the types of research that may be possible, and the difficulties inherent in each. His final conclusion is straightforward:

"Writing just after the decision in *Mapp* v. *Ohio,* Francis A. Allen declared that up to that time, 'no effective quantitative measure of the rule's deterrent efficacy has been devised or applied.' [Allen, Federalism and the Fourth Amendment: A Requiem for *Wolf,* 1961 Sup. Ct. Rev. 1, 34.] That conclusion is not yet outdated. The foregoing findings represent the largest fund of information yet assembled on the effect of the exclusionary rule, but they obviously fall short of an empirical substantiation or refutation of the deterrent effect of the exclusionary rule." 37 U. Chi. L. Rev., at 709.

More recently, Canon, Is the Exclusionary Rule in Failing Health? Some New Data and a Plea against a Precipitous Conclusion, 62 Ky. L. J. 681 (1974), discusses the data collected and reviewed by Oaks, and explores the difficulties in drawing conclusions from that data. The paper also reviews studies that appeared subsequent to the Oaks article: Spiotto, Search and Seizure: An Empirical Study of the Exclusionary Rule and its Alternatives, 2 J. Legal Studies 243 (1973]; and two papers by Michael Ban, The Impact of *Mapp* v. *Ohio* on Police Behavior (delivered at the annual meeting of the Midwest Political Science Ass'n., Chicago, May 1973) and Local Courts v. The Supreme Court: The Impact of *Mapp* v. *Ohio* (delivered at the annual meeting of the American Political Science Ass'n. New Orleans, September 1973). Canon describes his own research, but his data and conclusions appear to suffer from many of the same difficulties and faults present in the prior studies, many of which are explicitly recognized. Consequently, although Canon argues in favor of retaining the exclusionary rule while Oaks argued against it, Canon's conclusions are no more firm than were Oaks': "Consequently, our argument is negative rather than positive; we are maintaining that the evidence from the 14 cities certainly does not support a conclusion that the exclusionary rule had no impact upon arrests in search-and-seizure type crimes in the years following its imposition." Canon, *supra,* at 707; "Consequently, we cannot confidently attribute the increased use of search warrants entirely or even primarily to police reaction to the exclusionary rule." *Id.,* at 713. See also *id.,* at 724-725 and at 725-726. Canon concedes that "the inconclusiveness of our findings is real enough," *id.,* at 726, but argues that the exclusionary rule should be given time to take effect. "Only after a substantial amount of time has passed do trends of changing behavior (if any] become apparent." *Id.,* at 727. One might wonder why, if the substantial amount of time necessary for the rule to take effect is extremely relevant, the study fails to take into account the fact that over half the States have had an exclusionary rule for a significantly greater length of time than *Mapp* has been on the books.

Most recently, Comment, On the Limitations of Empirical Evaluations of the Exclusionary Rule: A Critique of the Spiotto Research and *United States* v. *Calandra,* 69 Nw. U. L. Rev. 740 (1974), reviews the Oaks, Canon, and Spiotto papers and the studies mentioned therein. The comment discusses the design difficulties present and involved in studying the deterrent effect of the exclusionary rule in general. Although a proponent of the rule, the author concludes:

"A review of Spiotto's research and that conducted by others does not demonstrate the ineffectiveness of the exclusionary rule. Rather, it tends to illustrate the obstacles that stand in the way of any sound, empirical evaluation of the rule. When all factors are considered, there is virtually no likelihood that the Court is going to receive any 'relevant statistics' which objectively measures the 'practical efficacy' of the exclusionary rule." *Id.,* at 763-764.

The final conclusion is clear. No empirical researcher, proponent or opponent of the rule, has yet been able to establish with any assurance whether the rule has a deterrent effect even in the situations in which it is now applied. It is, of course, virtually impossible to study the marginal deterrence added to *Mapp* by the *Elkins* silver platter rule because of the difficulty of controlling for the effect of intersovereign exclusion.

We are aware of no study on the possible deterrent effect of excluding evidence in a civil proceeding.

[23] For discussion of the variables involved, see Canon, *supra;* Geller, *supra;* Kaplan, *supra;* Milner, *supra;* Oaks, *supra;* Wright, Must the Criminal Go Free if the Constable Blunders?, 50 Tex. L. Rev. 736 (1972]; Comment, On the Limitations of Empirical Evaluations of the Exclusionary Rule: A Critique of the Spiotto Research and *United States* v. *Calandra, supra.*

[24] Studies have attempted to compare the experience in countries without the exclusionary rule with the experience in this country. See, *e.g.,* Oaks, *supra,* at 701-706; Spiotto, The Search and Seizure Problem —The Canadian Tort Remedy and the U.S. Exclusionary Rule, 1 J. Police Sci. & Ad. 36 (1973). See generally The Exclusionary Rule Regarding Illegally Seized Evidence: An International Symposium, 52 J. Crim. L. C. & P. S. 245 (1961). The difficulties in drawing conclusions from cross-cultural comparisons are self-evident. See also Canon, *supra,* at 692 n. 53.

[25] See generally Canon, at 713-717, 723-725; Katz, *supra;* Murphy, Judicial Review of Police Methods in Law Enforcement, 44 Tex. L. Rev. 969, 941-943 (1966).

[26] We do not mean to imply that more accurate studies could never be developed, or that what statisticians refer to as "triangulation" might not eventually provide us with firmer conclusions. We just do not find that the studies now available provide us with reliable conclusions.

"Empirical statistics are not available to show that the inhabitants of states which follow the exclusionary rule suffer less from lawless searches and seizures than do those of states which admit evidence unlawfully obtained. Since as a practical matter it is never easy to prove a negative, it is hardly likely that conclusive factual data could ever be assembled. For much the same reason, it cannot positively be demonstrated that enforcement of the criminal law is either more or less effective under either rule." *Elkins* v. *United States,* 364 U.S., at 218.

If the exclusionary rule is the strong medicine that its proponents claim it to be, then its use in the situations in which it is now applied (resulting, for example, in this case in frustration of the Los Angeles police officers' good-faith duties as enforcers of the criminal laws) must be assumed to be a substantial and efficient deterrent. Assuming this efficacy, the additional marginal deterrence provided by forbidding a different sovereign from using the evidence in a civil proceeding surely does not outweigh the cost to society of extending the rule to that situation.[27] If, on the other hand, the exclusionary rule does not result in appreciable deterrence, then, clearly, its use in the instant situation is unwarranted. Under either assumption, therefore, the extension of the rule is unjustified.[28]

In short, we conclude that exclusion from federal civil proceedings of evidence unlawfully seized by a state criminal enforcement officer has not been shown to have a sufficient likelihood of deterring the conduct of the state police so that it outweighs the societal costs imposed by the exclusion. This Court, therefore, is not justified in so extending the exclusionary rule.[29]

Respondent argues, however, that the application of the application of the exclusionary rule to civil proceedings long has been recognized in the federal courts. He cites a number of cases.[30] But respondent does not critically distinguish between those cases in which the officer committing the unconstitutional search or seizure was an agent of the sovereign that sought to use the evidence, on the one hand, and those cases, such as the present one, on the other hand, where the officer has no responsibility or duty to, or agreement with, the sovereign seeking to use the evidence.[31]

The seminal cases that apply the exclusionary rule to a civil proceeding involve "intrasovereign" violations,[32] a situation we need not consider here. In some cases the courts have refused to create an exclusionary rule for either inter- or intrasovereign violations in proceedings other than strictly criminal prosecutions. See *United States ex rel. Sperling* v. *Fitzpatrick,* 426 F. 2d 1161 (CA2 1970) (intrasovereign/parole revocation); *United States* v. *Schipani,* 435 F. 2d 26 (CA2 1970), cert. denied, 401 U.S. 983 (1971) (intersovereign/sentencing).[33] And in *Compton* v. *United States,* 334 F. 2d 212, 215-216 (1964), a case remarkedly like this one, the Fourth Circuit held that the presumption of correctness given a tax assessment was not affected by the fact that the assess-

[27] If the exclusionary rule is not "strong medicine," but does provide some marginal deterrence in the criminal situations in which it is now applied, that marginal deterrence is diluted by the attenuation existing when a different sovereign uses the material in a civil proceeding, and we must again find that the marginal utility of the creation of such a rule is outweighed by the costs it imposes on society.

[28] "[W]e simply decline to extend the court-made exclusionary rule to cases in which its deterrent purpose would not be served." *Desist* v. *United States,* 394 U.S. 244, 254 n. 24 (1969).

"As with any remedial device, the application of the rule has been restricted to those areas where its remedial objectives are thought most efficaciously served." *United States* v. *Calandra,* 414 U.S., at 348.

"Where the official action was pursued in complete good faith, however, the deterrence rationale loses much of its force." *Michigan* v. *Tucker,* 417 U.S. 433, 447 (1974). See *United States* v. *Peltier,* 422 U.S., at 537-538.

[29] "[I]t will not do to forget that the *Weeks* rule is a rule arrived at only on the nicest balance of competing considerations and in view of the necessity of finding some effective judicial sanction to preserve the Constitution's search and seizure guarantees. The rule is unsupportable as reparation or compensatory dispensation to the injured criminal; its sole rational justification is the experience of its indispensability in 'exert[ing] general legal pressures to secure obedience to the Fourth Amendment on the part of federal law-enforcing officers.' As it serves this function, the rule is a needed, but grud[g]ingly taken, medicament; no more should be swallowed than is needed to combat the disease. Granted that that so many criminals must go free as will deter the constables from blundering, pursuance of this policy of liberation beyond the confines of necessity inflicts gratuitous harm on the public interest as declared by Congress." A. Amsterdam, Search, Seizure, and Section 2255, 112 U. Pa. L. Rev. 378, 388-389 (1964) (footnotes omitted).

[30] *Suarez* v. *Commissioner,* 58 T. C. 792 (1972); *Pizzarello* v. *United States,* 408 F. 2d 579 (CA2), cert. denied, 396 U.S. 986 (1969); *Knoll Associates, Inc.* v. *F. T. C.,* 397 F. 2d 530 (CA7 1968); *Powell* v. *Suckert,* 125 U. S. App. D.C. 55, 366 F. 2d 634 (1966); *Rogers* v. *United States,* 97 F. 2d 691 (CA1 1938); *Anderson* v. *Richardson,* 354 F. Supp. 363 (SD Fla. 1973); *Iowa* v. *Union Asphalt & Roadoils, Inc.,* 281 F. Supp. 391 (SD Ia. 1968), aff'd *sub nom. Standard Oil Co.* v. *Iowa,* 408 F. 2d 1171 (CA8 1969); *United States* v. *Stonehill,* 274 F. Supp. 420 (SD Cal. 1967), aff'd, 405 F. 2d 738 (CA9 1968), cert. denied, 395 U.S. 960 (1969); *United States* v. *Blank,* 261 F. Supp. 180 (ND Ohio 1966); *Lassoff* v. *Gray,* 207 F. Supp. 843 (WD Ky. 1962).

[31] The decision by the District Court to suppress the evidence did not rest upon any finding of such an agreement or participation, and from the record it does not appear that any "federal participation" existed. See *Lustig* v. *United States, supra; Byars* v. *United States,* 273 U.S. 28 (1927). As stated above in n. 3, we decide the present case on the assumption that no such agreement or arrangement existed. Respondent remains free on remand to attempt to prove that there was federal participation in fact. If he succeeds in that proof, he raises the question, not presented by this case, whether the exclusionary rule is to be applied in a civil proceeding involving an intrasovereign violation.

It is well established, of course, that the exclusionary rule, as a deterrent sanction, is not applicable where a private party or a foreign government commits the offending act. See *Burdeau* v. *McDowell,* 256 U.S. 465 (1921); *United States* v. *Stonehill, supra.*

[32] See *Pizzarello* v. *United States, supra; Knoll Associates, Inc.* v. *F. T. C., supra; Powell* v. *Zuckert, supra; Iowa* v. *Union Asphalt & Roadoils, Inc., supra; United States* v. *Blank, supra.* See also *Hand* v. *United States,* 441 F. 2d 529 (CA5 1971).

[33] We express no view on the issue whether sentencing and parole revocation proceedings constitute "civil proceedings" for the purposes of the principles announced in this opinion.

ment was based upon evidence unconstitutionally seized by state criminal enforcement officers. Only one case cited by the respondent squarely holds that there must be an exclusionary rule barring use in a civil proceeding by one sovereign of material seized in violation of the Fourth Amendment by an officer of another sovereign.[34] In *Suarez* v. *Commissioner,* 58 T. C. 792 (1972) (reviewed by the court, with two judges dissenting), the Tax Court determined that the exclusionary rule should be applied in a situation similar to the one that confronts us here.

The court concluded that

> "any competing consideration based upon the need for effective enforcement of civil liabilities (compare *Elkins* v. *United States* . . .) must give way to the higher goal of protection of the individual and the necessity for preserving confidence in, rather than encouraging contempt for, the processes of Government." *Id.,* at 805.

No appeal was taken.

We disagree with the broad implications of this statement of the Tax Court for two reasons. To the extent that the court did not focus on the deterrent purpose of the exclusionary rule, the law has since been clarified. See *United States* v. *Calandra, supra; United States* v. *Peltier, supra.* Moreover, the court did not distinguish between inter- and intrasovereign uses of unconstitutionally seized material. Working, as we must, with the absence of convincing empirical data, common sense dictates that the deterrent effect of the exclusion of relevant evidence is highly attenuated when the "punishment" imposed upon the offending criminal enforcement officer is the removal of that evidence from a civil suit by or against a different sovereign. In *Elkins* the Court indicated that the assumed interest of criminal law enforcement officers in the criminal proceedings of another sovereign counterbalanced this attenuation sufficiently to justify an exclusionary rule. Here, however, the attenuation is further augmented by the fact that the proceeding is one to enforce only the civil law of the other sovereign.

This attenuation, coupled with the existing deterrence effected by the denial of use of the evidence by either sovereign in the criminal trials with which the searching officer is concerned, creates a situation in which the imposition of the exclusionary rule sought in this case is unlikely to provide significant, much less substantial, additional deterrence. It falls outside the offending officer's zone of primary interest. The extension of the exclusionary rule, in our view, would be an unjustifiably drastic action by the courts in the pursuit of what is an undesired and undesirable supervisory role over police officers.[35] See *Rizzo* v. *Goode,* 423 U.S. 362 (1976).

In the past this Court has opted for exclusion in the anticipation that law enforcement officers would be deterred from violating Fourth Amendment rights. Then, as now, the Court acted in the absence of convincing empirical evidence and relied, instead, on its own assumptions of human nature and the interrelationship of the various components of the law enforcement system. In the situation before us, we do not find sufficient justification for the drastic measure of an exclusionary rule. There comes a point at which courts, consistent with their duty to administer the law, cannot continue to create barriers to law enforcement in the pursuit of a supervisory role that is properly the duty of the Executive and Legislative Branches. We find ourselves at that point in this case. We therefore hold that the judicially created exclusionary rule should not be extended to forbid the use in the civil proceeding of one sovereign of evidence seized by a criminal law enforcement agent of another sovereign.

The judgment of the Court of Appeals is reversed and the case is remanded for further proceedings consistent with the opinion.

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[34] In *Anderson* v. *Richardson,* 354 F. Supp. 363 (SD Fla. 1973), which otherwise might be in this category, the trial court relied on *Pizzarello, supra,* in enjoining a tax assessment based upon illegally seized evidence. The Government had conceded, however, that the jeopardy assessment upon which it relied could not ultimately succeed. *Id.,* at 366. To the extent that dicta in that case might be relevant, the court failed to note that *Pizzarello* concerned an intra-sovereign situation.

In *United States* v. *Chase,* 67-1 U. S. T. C. ¶ 15733 (D. C. 1966), the District Court relied entirely upon principles of judicial integrity in excluding from a tax proceeding evidence unconstitutionally seized by state agents. *Id.,* at p. 84, 477. As noted previously, the Court has since clarified the fact that the primary, if not the sole, function of the exclusionary rule is deterrence. See *United States* v. *Calandra, supra; United States* v. *Peltier, supra.* See also n. 35, *infra.*

[35] To the extent that recent cases state that deterrence is the prime purpose of the exclusionary rule, and that "judicial integrity" is a relevant, albeit subordinate factor, we hold that in this case considerations of judicial integrity do not require exclusion of the evidence.

Judicial integrity clearly does not mean that the courts must never admit evidence obtained in violation of the Fourth Amendment. The requirement that a defendant must have standing to make a motion to suppress demonstrates as much. See *Alderman* v. *United States, supra.*

The primary meaning of "judicial integrity" in the context of evidentiary rules is that the courts must not commit or encourage violations of the Constitution. In the Fourth Amendment area, however, the evidence is unquestionably accurate, and the violation is complete by the time the evidence is presented to the court. See *United States* v. *Calandra,* 414 U.S., at 347, 354. The focus therefore must be on the question whether the admission of the evidence encourages violations of Fourth Amendment rights. As the Court has noted in recent cases, this inquiry is essentially the same as the inquiry into whether exclusion would serve a deterrent purpose. See *United States* v. *Peltier,* 422 U.S., at 538; *Michigan* v. *Tucker,* 417 U.S., at 450 n. 25. The analysis showing that exclusion in this case has no demonstrated deterrent effect and is unlikely to have any significant such effect shows, by the same reasoning, that the admission of the evidence is unlikely to encourage violations of the Fourth Amendment. The admission of evidence in a federal civil proceeding is simply not important enough to state criminal enforcement officers to encourage them to violate Fourth Amendment rights (and thus to obtain evidence that they are unable to use in either state or federal criminal proceedings). In addition, the officers here were clearly acting in good faith, see n. 1, *supra,* a factor that the Court has recognized reduces significantly the potential deterrent effect of exclusion. See *Michigan* v. *Tucker,* 417 U.S., at 447; *United States* v. *Peltier,* 422 U.S., at 39.

It is so ordered.

MR. JUSTICE STEVENS took no part in the consideration or decision of this case.

Delegation Order No. 75 (Rev. 6) (Effective May 19, 1976)

Authority of Regional Appellate Division in Offers in Compromise

Pursuant to the authority vested in the Commissioner of Internal Revenue by Treasury Department Order No. 150-25, dated June 1, 1953, as amended by Order No. 180, dated November 17, 1953, and Order No. 150-36, dated August 17, 1954 [1954-2 C.B. 733], 26 CFR 301.7122-1 and 26 CFR 301.7701-9, it is hereby ordered:

1. Each Assistant Regional Commissioner (Appellate), and each Chief, Assistant Chief, and Conferee-Special Assistant, Appellate Branch Office, is authorized to determine the disposition to be made of any offer in compromise submitted under the provisions of section 7122 of the Internal Revenue Code of 1954, in which (a) the proponent does not agree with the rejection or proposed rejection of the offer in the district office, the Office of International Operations or a Service Center and requests regional Appellate Division consideration or (b) the liability was previously determined by a regional Appellate Division and the offer is based on doubt as to liability or doubt as to both liability and collectibility.

2. A determination by regional Appellate Division officials to accept an offer (other than one involving specific penalties only) based solely on doubt as to liability will be subject to approval by the Regional Commissioner if the unpaid amount of tax (including any interest, penalty, additional amount or addition to the tax) is $100,000 or more.

3. A determination by regional Appellate Division officials to accept an offer (other than one involving specific penalties only) based solely on doubt as to collectibility or on doubt as to collectibility and liability will be subject to approval by the Director, Collection Division, if the unpaid amount of tax (including any interest, penalty, additional amount or addition to the tax) is $100,000 or more.

4. The authorities delegated herein may not be redelegated and are not applicable to cases arising under tax laws relating to wagering, narcotics, marihuana, alcohol, tobacco or firearms (other than firearms taxes imposed by sections 4181 and 4182 of the Internal Revenue Code of 1954 and sections 2700 and 3407 of the Internal Revenue Code of 1939) or to offers in compromise coming within the jurisdiction of the Chief Counsel under existing procedures, rules or delegations.

5. This Order supersedes Delegation Order No. 75 (Rev. 5), issued November 23, 1970 [1971-1 C.B. 655].

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on May 20, 1976, 8:45 a.m., and published in the issue of the Federal Register for May 21, 1976, 41 F.R. 20897)

Delegation Order No. 96 (Rev. 3) (Effective July 12, 1976)

Application of Rulings Without Retroactive Effect

1. Pursuant to authority granted to the Commissioner of Internal Revenue by 26 CFR 301.7805-1(b):

a. the Assistant Commissioner (Technical) and the Deputy Assistant Commissioner (Technical) are hereby authorized to prescribe the extent, if any, to which any ruling issued by or pursuant to authorization from the Assistant Commissioner relating to the internal revenue laws shall be applied without retroactive effect.

b. the Assistant Commissioner (Employee Plans and Exempt Organizations) and the Deputy Assistant Commissioner (Employee Plans and Exempt Organizations) are hereby authorized to prescribe the extent, if any, to which any ruling issued by or pursuant to authorization from the Assistant Commissioner relating to the internal revenue laws shall be applied without retroactive effect.

2. This authority may not be redelegated.

3. This Order supersedes Delegation Order No. 96 (Rev. 2) [1975-1 C.B. 637] issued January 15, 1975.

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on July 13, 1976, 8:45 a.m., and published in the issue of the Federal Register for July 14, 1976, 41 F.R. 29000)

Delegation Order No. 114 (Rev. 1) (Effective November 3, 1976)

Designation To Act as "Competent or Taxation Authority" Under Tax Treaties

1. Pursuant to the authority delegated to me by the Treasury Department Order No. 150-83 [1973-2 C.B. 508], there is hereby delegated to the Assistant Commissioner (Compliance) the authority to act as "competent or taxation authority" under tax treaties of the United States. This authority includes the administration of the operating provisions of tax treaties as well as the interpretation or application of such treaties. With respect to the interpretation or application of tax treaties, the Assistant Commissioner (Compliance) shall act in all such matters only after the concurrence of the Assistant Commissioner (Technical).

2. The authority delegated herein may not be redelegated.

3. Delegation Order No. 114, issued June 26, 1970 [1970-2 C.B. 489], is superseded.

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on November 5, 1976, 8:45 a.m., and published in the issue of the Federal Register for November 8, 1976, 41 F.R. 49209)

Delegation Order No. 137 (Rev. 1) (Effective November 10, 1976)

Approving Requests to Examine Books of Account and Religious Activities of a Church or Convention or Association of Churches

1. Pursuant to the authority vested in the Commissioner of Internal Revenue under 26 CFR 301.7701-9 and 26 CFR 301.7605-1(c), the Regional Commissioners are authorized to approve a request to examine books of account and religious activities of a church or convention or association of churches.

2. This authority may not be redelegated.

3. This Order supersedes Delegation Order No. 137, issued June 27, 1973 [1973-2 C.B. 464].

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on October 26, 1976, 8:45 a.m., and published in the issue of the Federal Register for October 27, 1976, 41 F.R. 47085)

Delegation Order No. 139 (Rev. 2) (Effective June 23, 1976)

Authority to Extend the Correction Period and the Allowable Distribution Period Relating to Private Foundation and Employee Plans Matters

1. Pursuant to the provisions of 26 CFR 53.4941(e)-1(d), 26 CFR 53.4941(f)-1, 26 CFR 53.4942(a)-1(c), 26 CFR 53.4944-5, 26 CFR 53.4945-1(e), IRC 4971(c)(3), IRC 4975(f)(6), and the authority vested in the Commissioner of Internal Revenue by Treasury Department Order No. 150-37, dated March 17, 1955, there is hereby delegated to the District Director of Internal Revenue for each of the key districts and the Assistant Regional Commissioner (EP/EO) for each of the regions for Employee Plans and Exempt Organizations matters the authority to:

(a) Extend the correction period for acts of self-dealing under IRC 4941, failures to distribute income under IRC 4942, investments which jeopardize charitable purpose under IRC 4944, and taxable expenditures under IRC 4945;

(b) Extend the allowable distribution period for failures to distribute income under IRC 4942; and

(c) Extend the correction period for failures to meet minimum funding standards under IRC 4971, and correction of prohibited transactions under IRC 4975.

2. The authority delegated herein may be redelegated, but not lower than to Group Managers in Key District Offices and to Executive Assistants in Regional Offices.

3. This Order supersedes Delegation Order No. 139 (Rev. 1) issued January 2, 1975 [1975-1 C.B. 641].

WILLIAM E. WILLIAMS,
Acting Commissioner.

(Filed by the Office of the Federal Register on June 23, 1976; 8:45 a.m., and published in the issue of the Federal Register for June 24, 1976, 41 F.R. 26036)

Delegation Order No. 154

Decision on Reports of Refunds and Credits to the Joint Committee on Internal Revenue Taxation

1. Pursuant to the authority vested in the Commissioner of Internal Revenue by Section 3777(a) of the Internal Revenue Code of 1939, Treasury Department Order No. 150-2, dated May 15, 1952, Sections 6405(a) and 7851(b)(3) of the Internal Revenue Code of 1954, and Treasury Department Order No. 150-36, [1954-2 C.B. 733] dated August 17, 1954, authority is hereby delegated to:

a. Regional Commissioners to make the decision and report to the Joint Committee on Internal Revenue Taxation as required by Section 6405(a) of the Internal Revenue Code of 1954 on cases within their regional jurisdiction.

b. The Regional Commissioner, Mid-Atlantic Region, to make the decision and report to the Joint Committee on Internal Revenue Taxation as required by Section 6405(a) of the Internal Revenue Code of 1954 on cases within the jurisdiction of the Director of International Operations.

c. Assistant Commissioner (Compliance) to take final action for the Commissioner on issues or matters formally presented by the Joint Committee on Internal Revenue Taxation relating to reports submitted under Section 6405(a) of the Internal Revenue Code of 1954.

2. The authority delegated herein may not be redelegated.

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on May 20, 1976; 8:45 a.m., and published in the issue of the Federal Register for May 21, 1976, 41 F.R. 20898)

Delegation Order No. 155 (Effective May 19, 1976)

Recommendations Concerning Settlement Offers in Refund Suits

1. Pursuant to the authority vested in the Commissioner of Internal Revenue by 26 CFR 301.7122-1 and 26 CFR 301.701-9, the Assistant Commissioner (Compliance) is delegated the authority to sign recommendation letters to the Department of Justice concerning Settlement Offers for years or parties not in suit, but related to pending refund suits for other years or parties.

2. The authority delegated herein may not be redelegated.

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on May 20, 1976 at 8:45 a.m., and published in the Federal Register for May 21, 1976, 41 F.R. 20897)

Delegation Order No. 156 (Effective May 19, 1976)

Authority to Permit Inspection of Certain Returns and Related Documents as Set Forth in Treas. Reg. 301.6103(a)-1 and 301.9000-1 and to Disclose Certain Information under 26

U.S.C. 6103(f) as to Persons Filing Income Tax Returns

1. Pursuant to authority vested in the Commissioner of Internal Revenue by 26 CFR 301.6103(a)-1 and 26 CFR 301.9000-1, authority is hereby delegated to the Regional Commissioners, Assistant Commissioner (Compliance), District Directors, Service Center Directors, Director of International Operations, and the Chief, Disclosure Staff, to permit inspection of returns in their custody by the persons and subject to the conditions as prescribed for such persons in 26 CFR 301.6103(a)-1(c), and by the same persons, and subject to the conditions as prescribed for such persons in 26 CFR 301.6103(a)-1(c), with respect to whom inspection is discretionary under 26 CFR 301.9000-1. The authority delegated in this paragraph may be redelegated only to Assistant District and Service Center Directors, Assistants to the District and Service Center Directors, Division Chiefs, and Disclosure Officers, and such redelegation is limited to the inspection of returns as defined in 26 CFR 301.6103(a)-1(a)(3)(i)(a).

2. Regional Commissioners, Assistant Commissioner (Compliance), District Directors, Service Center Directors, the Director of International Operations, and the Chief, Disclosure Staff, are authorized to furnish returns, as defined in 26 CFR 301.6103(a)-1(a)(3), or copies thereof, without written application, to United States Attorneys and attorneys of the Department of Justice, in accordance with paragraph (h) of section 301.6103(a)-1, for official use in proceedings before a U.S. grand jury or in litigation in any court provided such use pertains to the prosecution of claims and demands by, and offenses against, the United States, or the defense of claims and demands against the United States or officers and employees thereof, in cases arising under the internal revenue laws or related statutes which were referred by the Department of the Treasury to the Department of Justice for such prosecution or defense. The authority delegated in this paragraph of this order does not extend to the furnishing of returns of members of the judiciary, both Federal and State, or of third parties not directly involved in the transactions of the taxpayer. The authority delegated in this paragraph may be redelegated only to Assistant District and Service Center Directors, Assistants to the District and Service Center Directors, Division Chiefs, Assistant Chief, Disclosure Staff, and Disclosure Officers.

3. With respect to matters referred to the Department of Justice by the Department of the Treasury, the authority to furnish returns of the judiciary, both Federal and State, and of third parties not directly involved in the transactions of the taxpayer, is delegated to the Assistant Commissioner (Compliance) and the Chief, Disclosure Staff. The Assistant Commissioner (Compliance) and the Chief, Disclosure Staff, should act in all such matters only after coordination with the Disclosure Division, Office of the Chief Counsel. The authority delegated in this paragraph may not be redelegated.

4. Regional Commissioners, Assistant Commissioner (Compliance), District Directors, Service Center Directors, the Director of International Operations, and the Chief, Disclosure Staff, may furnish an affirmative or negative response to inquiries from the Department of Justice, in accordance with paragraph (h) of section 301.6103(a)-1, concerning whether a prospective juror in any Federal litigation has been or is being investigated by the Internal Revenue Service. The authority delegated in this paragraph may be redelegated to Assistant District and Service Center Directors, Assistants to the District and Service Center Directors, Division Chiefs, Assistant Chief, Disclosure Staff, and Disclosure Officers.

5. The Assistant Commissioner (Compliance) and the Chief, Disclosure Staff, are authorized to act on all other requests from United States Attorneys and attorneys of the Department of Justice for inspection and copies of returns, in accordance with paragraphs (g) and (h) of section 301.6103(a)-1, and by the same persons, and subject to the conditions as prescribed for such persons in 26 CFR 301.6103(a)-1(g) and (h), with respect to whom inspection is discretionary under 26 CFR 301.9000-1. The authority delegated in this paragraph may be redelegated by the Assistant Commissioner (Compliance) to the Assistant Chief, Disclosure Staff, and to Tax Law Specialists GS-987-14 in the Disclosure Staff.

6. Pursuant to authority vested in the Commissioner of Internal Revenue by Treasury Department Order No. 150-37, dated March 17, 1955, District Directors, Service Center Directors, and the Director of International Operations are authorized, after inquiry has been made, to inform an inquirer as to whether the person who is the subject of the injuiry has, or has not, filed an income tax return with their office for the taxable year in question. The Assistant Commissioner (Compliance) and the Chief, Disclosure Staff, also are authorized to act on requests made under 26 U.S.C. 6103(f). The authority delegated in this paragraph may be redelegated to Assistant District and Service Center Directors, Assistants to the District and Service Center Directors, Division Chiefs, Assistant Chief, Disclosure Staff, and Disclosure Officers.

7. The authority vested in the Commissioner by 26 CFR 301.9000-1 to determine whether or not information received by Internal Revenue Service employees or employees of the Office of Chief Counsel relating to nontax crimes (such as homicide, rape, burglary, robbery or similar crimes) may be disclosed to appropriate Federal, State or local law enforcement officials is delegated to the Assistant Commissioner (Compliance) and the Deputy Assistant Commissioner (Compliance). This authority is limited to those situations in which it appears that the information sought to be disclosed may be tax return related or otherwise involves income or other financial information of an individual or entity. The Assistant Commissioner (Compliance)

and the Deputy Assistant Commissioner (Compliance) are authorized to approve or deny such requests for disclosure, based on their determination, made in coordination with the Director, Disclosure Division, Office of Chief Counsel. The authority as delegated in this paragraph may not be redelegated.

8. Disclosure of information to appropriate Federal, State or local law enforcement officials may be made by Internal Revenue Service employees and employees of the Office of Chief Counsel in nontax crimes described in paragraph 7 which do not involve tax return related information or the income or other financial information of an individual or entity, in accordance with the provisions of the Disclosure of Official Information Handbook, IRM 1272.

9. The authority vested in the Commissioner by 26 CFR 301.9000-1 and 301.6103(a)-1(c), (d), (e), (f), (g) and (h) and not heretofore delegated is delegated by this Order to the Deputy Commissioner, Regional Commissioners, Assistant Commissioner (Compliance), Deputy Assistant Commissioner (Compliance), and the Chief, Disclosure Staff, to the extent as described below:

(a) Regional Commissioners are authorized to determine whether or not officers and employees of the Internal Revenue Service assigned to the region, including employees of the Office of the Chief Counsel, will be permitted to testify or produce Service documents because of a request or demand as referred to in paragraph (d)(1)(i) and (ii) of 26 CFR 301.9000-1 in Civil litigation pending in state or local Courts and only involving state or local authorities and private parties. The Regional Commissioners should act in all such matters only after coordination with the Office of Regional Counsel. The authority as delegated in this paragraph may not be redelegated.

(b) The Assistant Commissioner (Compliance) and the Deputy Assistant Commissioner (Compliance) are authorized to determine whether or not officers and employees of the Internal Revenue Service, including employees of the Office of Chief Counsel, will be permitted to testify or produce Service documents because of a request or demand as referred to in paragraph (d)(1)(i) and (ii) of 26 CFR 301.9000-1 in all matters not described in (a) above. The Assistant Commissioner (Compliance) or the Deputy Assistant Commissioner (Compliance) should act in all such matters only after coordination with the Disclosure Division of the Office of Chief Counsel. The authority as delegated in this paragraph may not be redelegated.

(c) The Assistant Commissioner (Compliance) and the Chief, Disclosure Staff, are authorized to permit inspection or production of documents or information of the Internal Revenue Service by any applicant eligible therefor under 26 CFR 301.6103(a)-1(e) and (a)-1(f), and by the same applicant, and subject to the conditions as prescribed for such applicant in 26 CFR 301.6103(a)-1(e) and (a)-1(f), with respect to whom inspection is discretionary under 26 CFR 301.9000-1. The authority as delegated in this paragraph may not be redelegated.

10. Whenever it is determined that a return or related document is available for disclosure in a particular case, a copy or certified copy may be furnished the party requesting the same.

11. This Order supersedes Delegation Order No. 86 (Rev. 5) [1976-1 C.B. 539] issued January 9, 1976, and Delegation Order No. 83 (Rev. 5) [1974-2 C.B. 464] issued July 15, 1974.

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on May 20, 1976, 8:45 a.m.; and published in the issue of the Federal Register for May 21, 1976, 41 F.R. 20898)

Delegation Order No. 157 (Effective September 15, 1976)

Seizure and Forfeiture of Personal Property

(1) Pursuant to the authority granted to the Commissioner of Internal Revenue by 26 CFR 403.403-65.

(a) Special Agents and Internal Security Inspectors are authorized:

1. to seize personal property for forfeiture to the United States when involved, used, or intended to be used, in violation of the internal revenue laws other than Chapters 35, 51, 52 and 53 of the Internal Revenue Code of 1954;

2. to estimate the value of seized personal property and if valued at $2,500 or less to cause a list to be prepared and appraisal to be obtained and to attest such list and appraisement, and to publish notice, as provided in 26 CFR 403.26; and

3. to cause notice of sale to be placed in accordance with 26 CFR 403.55 and to re-advertise the property when necessary in accordance with 26 CFR 403.57.

(b) District Directors and Regional Inspectors are authorized:

1. to make the determinations concerning type and conditions of cost bonds as provided in 26 CFR 403.27;

2. to exercise the authority of the Commissioner concerning disposition of perishable goods provided in 26 CFR 403.30;

3. to execute the declaration of forfeiture showing that personal property has been forfeited to the United States;

4. to acquire for official use seized property by exercising the authority of the Commissioner provided in 26 CFR 403.44;

5. to determine that seized property shall be sold at public auction as provided in 26 CFR 403.55;

6. to order the destruction of any coin-operated gaming device under the provisions of 26 CFR 403.65.

(c) The Director, Intelligence Division, and the Director, Internal Security Division, are authorized:

1. to allow or deny petitions for remission or mitigation of forfeiture, accept or reject any offer in compromise of the liability to forfeiture of personal property, and to make the necessary determinations and notifications, as provided in 26 CFR 403.43,

and to authorize the District Directors or Regional Inspectors to notify the petitioner or offeror of the action taken on the petition or offer.

(2) The authority delegated herein may not be redelegated.

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on September 14, 1976, 8:45 a.m., and published in the issue of the Federal Register for September 15, 1976, 41 F.R. 39355.)

Delegation Order No. 158 (Effective September 17, 1976)

Deciding Appeals of Determinations of Tax Liability and/or Excise Taxes Involving Employee Plans and Exempt Organizations

1. Pursuant to the authority vested in the Commissioner of Internal Revenue by Treasury Department Order 150-37, the authority to decide appeals of determinations of tax liability and/or related excise taxes involving employee plans and exempt organizations is hereby delegated to the following officials:

(a) Assistant Regional Commissioner (Appellate);

(b) Chiefs and Assistant Chiefs, Appellate Branch Offices;

(c) Conferee-Special Assistants, Appellate Branch Offices; and

(d) Chief and Section Chief, District Conference Function.

2. This authority may not be redelegated.

DONALD C. ALEXANDER,
Commissioner

(Filed by the Office of the Federal Register on September 16, 1976, 8:45 a.m., and published in the issue of the Federal Register for September 17, 1976, 41 F.R. 40192)

Delegation Order No. 159 (Effective October 6, 1976)

Requests for Variance from Minimum Funding Standards (IRC 412(d))

Pursuant to authority vested in the Commissioner of Internal Revenue by Treasury Department Order 150-37 dated March 17, 1955, there is hereby delegated to the Assistant Commissioner (Employee Plans/Exempt Organizations) and the Director, Actuarial Division, the authority to:

(1) Waive the minimum funding standards under IRC 412 in accordance with subsection (d) thereof, and

(2) perform the corresponding duties of the Secretary of the Treasury under section 303 of the Employee Retirement Income Security Act of 1974 (ERISA) [Pub. L. 94-306, 1974-3 C.B.] with respect to the minimum funding standards under ERISA section 302.

The authority delegated herein may not be redelegated.

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on October 13, 1976, 8:45 a.m., and published in the Federal Register for October 14, 1976, 41 F.R. 45034)

Delegation Order No. 160 (Effective October 14, 1976)

Authority of Regional Appellate Division in Termination of Taxable Year Assessments and Jeopardy Assessments

1. Pursuant to the authority vested in the Commissioner of Internal Revenue under 26 CFR 301.6020-1, 26 CFR 301.6201-1, 26 CFR 301.7701-9 and Treasury Department Order No. 150-37 dated March 17, 1955, authority is hereby delegated to each Assistant Regional Commissioner (Appellate), each Chief, and Assistant Chief, Appellate Branch Office, to conduct conferences and determine final disposition of requests for administrative reviews in termination of taxable year assessment and jeopardy assessment cases.

2. This authority may not be redelegated.

DONALD C. ALEXANDER,
Commissioner.

(Filed by the Office of the Federal Register on October 14, 1976, 8:45 a.m., and published in the issue of the Federal Register for October 15, 1976, 41 F.R. 45591)

Executive Order 11931

EXTENDING DIPLOMATIC PRIVILEGES AND IMMUNITIES TO PERMANENT OBSERVERS TO THE ORGANIZATION OF AMERICAN STATES AND TO MEMBERS OF THEIR DIPLOMATIC STAFFS

By virtue of the authority vested in me by the Act of November 7, 1973 (87 Stat. 560; 22 U.S.C. 288g), and as President of the United States of America, I extend to Permanent Observers to the Organization of American States, and to the members of the diplomatic staffs of such Permanent Observers, the same privileges and immunities, subject to corresponding conditions and obligations, as are enjoyed by diplomatic envoys accredited to the United States.

This Executive order shall be effective as of November 7, 1973. The enjoyment of privileges and immunities extended hereunder shall be subject to any Agreements entered into between the Government of the United States and the Organization of American States after that date.

GERALD R. FORD

The White House,
August 3, 1976.

(Filed by the Office of the Federal Register on August 3, 1976; 4:50 p.m., and published in the issue of the Federal Register for August 5, 1976, 41 F.R. 32689)

Notice.—List of Countries Requiring Cooperation with an International Boycott

Pursuant to the authority vested in the Secretary of the Treasury by section 1067(b) of the Tax Reform Act of 1976 and section 999(a)(3) of the Internal Revenue Code of 1954, the Department of the Treasury has compiled an initial list of countries which may require participation in, or cooperation with, an international boy-

cott as a condition of doing business within such country, or with the government, a company, or a national of such country (within the meaning of section 999(b) of the Internal Revenue Code of 1954).

The following countries may require participation in, or cooperation with, an international boycott, as a condition of doing business within such country, or with the government, a company, or a national of such country (within the meaning of section 999(b) of the Internal Revenue Code of 1954):

Bahrain	Qatar
Egypt	Saudi Arabia
Iraq	Syria
Jordan	United Arab Emirates
Kuwait	Yemen, Arab Republic
Lebanon	Yemen, Peoples Democratic Republic of
Libya	
Oman	

This list shall become effective on November 3, 1976.

WILLIAM E. SIMON,
Secretary of the Treasury

(Filed by the Office of the Federal Register on November 2, 1976, 11:31 a.m., and published in the issue of the Federal Register for November 3, 1976, 41 F.R. 48384)

Notice.—Tax Reform Act of 1976 Guidelines; International Boycotts

The Secretary of the Treasury has issued the following guidelines relating to the provisions of the Tax Reform Act of 1976. The guidelines may be used by taxpayers for guidance in resolving issues arising under section 999 of The Internal Revenue Code of 1954, as enacted in The Tax Reform Act of 1976. Written comments are invited on the guidelines and should be submitted in duplicate to: Assistant Secretary for International Affairs, U.S. Treasury Department, Washington, D.C. 20220; and Assistant Secretary for Tax Policy, U.S. Treasury Department, Washington, D.C. 20220.

GUIDELINES

Boycott Provisions (section 999) of the Internal Revenue Code

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In the questions and answers:

(a) Company A and Company B are companies organized under the laws of one of the states of the United States,

(b) Country X is a boycotting country, which, *inter alia,* boycotts Country Y;

(c) Country Y is a country boycotted by Country X;

(d) All references to "Sections" are to Sections of the Internal Revenue Code, as amended by the Tax Reform Act of 1976; and

(e) In parts H-M the answer which follows each question takes into account only the action described in the question and no other. Most questions and answers refer to a type of conduct which is referred to in section 999(b)(3) or section 999(b)(4). In many of these questions and answers the result would be the same if another type of conduct also referred to in section 999(b)(3) or section 999(b)(4) were substituted for the particular type of conduct referred to in the question. For example, in Question and Answer H-10 the result would be the same if "individuals of race R" were substituted for "individuals of religion R".

It should be recognized that in instances where the action described in the question by itself does not, according to the answer, provide sufficient evidence to support an inference that an agreement under section 999(b)(3) exists, an overall course of conduct which includes such action in addition to other actions could support such an inference.

A. *Boycott Reports.*

A-1. Q: Who must report as required by section 999(a)?

A: Generally, any United States person (within the meaning of section 7701(a)(30)), or any other person (within the meaning of section 7701(a)(1)) that either claims the benefit of the foreign tax credit under section 901, or owns stock of a DISC, is required to report under section 999(a) if it—

a. has operations; or

b. is a member of a controlled group, a member of which has operations; or

c. is a United States shareholder (within the the meaning of section 951(b)) of a foreign corporation that has operations; or

d. is a partner in a partnership that has operations; or

e. is treated under section 671 as the owner of a trust that has operations

in or related to a country (or with

the government, a company, or a national of a country) (i) which is on the list maintained by the Secretary under section 999(a)(3) or (ii) in which it has operations and which it knows or has reason to know requires participation in or cooperation with an international boycott as a condition of doing business therein (or with the government, a company or a national thereof) unless such participation or cooperation is sanctioned by section 999(b)(4)(A), (B) or (C). (For the definition of operations in or related to a country, see the questions under part B.) Additionally, if a person controls a corporation (within the meaning of section 304(c)), then under section 999(e) that person must report whether the corporation had reportable operations, whether the corporation reported such operations, and whether the corporation participated in or cooperated with the boycott. The corporation must make the same reports with respect to the operations and reports of the person controlling it.

A-2. Q: Do the reporting requirements of section 999(a) which refer to "United States shareholders" of foreign corporations require U.S. minority shareholders to report on the operations of such foreign corporations?

A: Yes. Under section 951(b) the term "United States shareholder" includes any United States person who owns (within the meaning of section 985(a)) or is considered as owning (by the application of the rules of ownership of section 985(b)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. The reporting requirement applies even if the United States shareholder is a minority shareholder and even if the foreign corporation is not a controlled foreign corporation within the meaning of section 957(a).

A-3. Q: If one member of a controlled group of corporations (within the meaning of section 993(a)(3)) files a report under section 999 with respect to the reportable operations of all members of that group, is this sufficient to discharge the reporting obligation of all members of the group?

A: Yes, provided that the common parent (as defined in the regulations under section 1504) files a consolidated return and the report on behalf of all members of the controlled group. In the absence of a consolidated return, each member of the controlled group must individually file the section 999 report. If a consolidated return is filed on behalf of some members of the controlled group, only one report need be filed with respect to those members. However, each other member must individually file the report.

A-4. Q: If one United States shareholder of a foreign corporation files a report under section 999 in respect of the reportable operations of the foreign corporation, is this sufficient to discharge the reporting obligations of all United States shareholders of the foreign corporation in respect of that corporation's operations?

A: No. Each United States shareholder of a foreign corporation must file the section 999 report in respect of the activities of that corporation. However, if two or more United States shareholders of the foreign corporation are included in the same consolidated return, only one report need be filed with respect to all United States shareholders included in the return.

A-5. Q: How will the reporting requirements under section 999(a), "International Boycott Reports by Taxpayers", be satisfied?

A: A taxpayer required to file an international boycott report under section 999(a) will fulfill this requirement by filing a new IRS Form 5713, "International Boycott Report Form", and all applicable supporting schedules and forms contained in the taxpayer's income tax returns which indicate the amounts and computations of benefits denied under sections 908, 952(a) and 995(b)(1) of the Internal Revenue Code. Form 5713, the only new IRS form pertaining to the international boycott provision, will be available early in 1977. Existing Form 1118 (Foreign Tax Credit), Form 1120-DISC (DISC Income), and Form 3646 (Subpart F Income) will contain new line entries to reflect tax benefits denied under the boycott provisions.

A-6. Q: What degree of confidentiality will the international boycott reports submitted by taxpayers receive?

A: The reports by taxpayers will be submitted as part of the income tax return and, therefore, will be accorded the same degree of confidential treatment under section 6103 as any other information contained in an income tax return.

A-7. Q: Where and how should the "International Boycott Report Form" be filed?

A: The "International Boycott Report Form", Form 5713, should be filed in duplicate by all reporting taxpayers. One copy of Form 5713 should be sent to the Internal Revenue Service Center, 11601 Roosevelt Blvd., Philadelphia, Pennsylvania 19155, and the other copy of Form 5713 should be attached to the taxpayer's income tax return which is filed with the taxpayer's customary Internal Revenue Service Center.

A-8. Q: Do individuals as well as corporations use Form 5713, "International Boycott Report Form"?

A: Yes. All taxpayers required to file a report under section 999(a) will use IRS Form 5713. However, some parts of the form apply to corporations only; individual taxpayers can ignore these parts and complete only the questions relevant to individuals (unless under section 999(e) the participation in or cooperation with the international boycott by a corporation is attributable to that individual). While all taxpayers reporting under section 999(a) are required to file Form 5713, the filing of Form 5713 does not necessarily fulfill all of the reporting requirements under section 999(a) (see the answer for Question A-5).

A-9. Q: Section 999(b)(4) permits a person to agree to comply with certain laws without being treated as having agreed to participate in or cooperate with an international boycott.

Company A agrees to comply with prohibitions on importation and exportation with respect to operations in or related to a country referred to in section 999(a)(1), as set forth in section 999(b)(4)(B) and section 999(b)(4)(C). Is Company A required to report the operations under such agreement on Form 5713, the "International Boycott Report Form"?

A: Yes, for the reasons stated in the answer to Question A-1, whether or not Company A agrees to comply with the prohibitions.

A-10. Q: Section 999(b)(4)(A) permits a person to meet requirements imposed by a foreign country with respect to an international boycott if United States law or regulations, or an Executive Order, sanctions participation in, or cooperation with, that international boycott. If a person's operations fall within this exception, is the person required to report such operations?

A: No. The reporting requirements with respect to operations under such international boycott agreements are waived.

A-11. Q: If Company A sells goods or services to Company B (or does other business with Company B) and Company B and Company A are unrelated, and Company A knows or has reason to know that Company B in turn will sell these goods or services for use in an international boycott enforcing country (within the meaning of section 999(b)(3)), and further, Company B participates in or cooperates with such boycott, is Company A required to report with respect to such operations?

A: No. Although such operations are related to a boycotting country (see the answer for Question B-1), the reporting requirements are waived for Company A, provided that Company A does not receive a request or participate in or cooperate with an international boycott under section 999(a)(2) or section 999(b)(3).

A-12. Q: Company A is a U.S. shareholder (within the meaning of section 951(b)) of Company C, a foreign corporation. Company A has a taxable year ending January 31, and Company C has a taxable year ending June 30. Both companies have operations in Country X, which is on the list maintained pursuant to section 999(a)(3). Who should file Form 5713 and for what period?

A: As indicated in the answer to Question A-1, Company C need not file Form 5713 unless it claims the benefit of the foreign tax credit under section 901 or owns stock of a DISC. Company A must file Form 5713 for periods ending January 31, and must report operations of Company C during Company C's taxable year ending within the period covered by Company A's report.

A-13. Q: In the case of a controlled group, what period of time is the international boycott report to cover, and when is the "International Boycott Report Form", Form 5713, to be filed?

A: For purposes of reporting and for purposes of determining the international boycott factor, all persons described in the answer to Question A-1 are to report all reportable operations by all members of the controlled group (or by any foreign corporation with a United States shareholder who is a member of the controlled group) for the taxable years of such members which end with or within the taxable year of the controlled group's common parent. In the event no common parent exists, the members of the controlled group are to elect the tax year of one of the members to serve as the common tax year for the group. It is contemplated that procedures for making an election will be specified in the instructions of the "International Boycott Report Form", Form 5713. The taxable year election is a binding election to be made once, with subsequent elections for alternative tax years granted only with the approval of the Secretary of the Treasury.

Individual members of the controlled group will continue to use their normal tax years for all other purposes, including adjustments required under sections 908, 952(a), and 995(b)(1). When the international boycott factor is used, the consolidated boycott factor, for that year, will be applied to the normal tax year of each taxpayer for determining adjustments under sections 908, 952(a), and 995(b)(1).

The income tax year of a taxpayer may differ from the reporting period covered by the "International Boycott Report Form." Therefore, the Form 5713 which is attached to, and filed with, the income tax return of the taxpayer will be the Form 5713 for the reporting year ending with or within the tax year of the taxpayer.

B. *Definition of "Operations."*

B-1. Q: Under what circumstances does a person have operations in, or related to, a boycotting country (or with the government, a company, or a national of that country)?

A: A person has operations in, or related to, a boycotting country (or with the government, a company, or a national of that country) if the operation in which it engages:

1. is carried on in whole or part in a boycotting country ("in a country");

2. is carried on outside a boycotting country either for or with the government, a company, or a national of a boycotting country ("with the government, a company, or a national of a country"); or

3. is carried on outside a boycotting country for the government, a company, or a national of a non-boycotting country if the person having the operation knows or has reason to know that a specific good or service produced by the operation is intended for use in a boycotting country or for the government, a company, or a national of a boycotting country ("related to a country").

The term "operation" encompasses all forms of business or commercial activities whether or not productive of income, including, but not limited to, sales; purchases; banking, financing and similar activities; extracting; processing; manufacturing; production; construction; transportation; activities ancilliary to the foregoing (e.g., con-

tract negotiating, advertising, site selecting, etc.); and the performance of services, whether or not ancilliary to the foregoing.

Operations described in principles 2 and 3 are illustrated in the following two examples:

(a) Company A engages in a joint venture manufacturing operation in a non-boycotting country with Company C, a company incorporated under the laws of Country X. Company A has operations "with" a company of a boycotting country.

(b) D, a national of a non-boycotting country has a contract to construct a dam in Country X. D subcontracts to Company A for the manufacture of a generator for the dam. The contract between D and Company A and the generator specifications indicate that the generator is for use in Country X. The contract specifies delivery of the generator to D f.o.b. New York. Company A has operations "related to" a boycotting country.

C. *Definition of "Reason To Know Requirement of Boycott Participation.*

C-1. Q: Under what circumstances, in the absence of a Treasury listing of a country, will it be deemed under section 999(a)(1)(B) that a person knows or has reason to know that participation in or cooperation with an international boycott is required as a condition of doing business within such country or with the government, a company, or a national of such country?

A: A person will be deemed to know or have reason to know that a country requires participation in or cooperation with an international boycott as a condition of doing business within a country or with the government, a company, or a national of a country, if that person receives what could be interpreted as an official request of that country to participate in or cooperate with an international boycott or if that person knows that others have received such requests. Whether a request could be interpreted as an official request of a country depends on an analysis of the facts and circumstances surrounding the request. However, the request need not be made directly by a government official or representative in order to be interpreted as an official request. Thus, for example, assume that Company A has a contract with the government of a boycotting country to build a dam in that country and is required under the contract to require its subcontractors to agree to participate in or cooperate with the boycott. Assume further that Company A requires Subcontractor B to make such an agreement as a condition of receiving the subcontract to build a generator for the dam. Company B will be deemed to have reason to know that participation in or cooperation with an international boycott is a condition of doing business within the boycotting country or with the government, a company, or a national of such country.

D. *Definition of "Clearly Separate and Identifiable Operations."*

D-1. Q: If a person or a member of a controlled group (within the meaning of section 993(a)(3) enters into an agreement which constitutes participation in or cooperation with an international boycott (within the meaning of section 999(b)(3)), what operations of that person or group will be considered as operations in connection with which such participation or cooperation occurred?

A: All operations of such person or such group in

(a) that country in connection with which the agreement is made; and

(b) any other country which requires participation in or cooperation with that boycott with respect to which the agreement is made;

will be presumed to be operations in connection with which there was participation in or cooperation with an international boycott. This presumption may be rebutted, however, if the person or group demonstrates that a particular operation is a clearly separate and identifiable operation from the operation with respect to which the agreement was made, and that no agreement constituting participation in or cooperation with an international boycott was made with respect to such separate and identifiable operation.

The presumption of participation in or cooperation with the boycott will not apply with respect to operations outside of the countries described in (a) and (b) above, but such operations will be considered as operations involving participation in or cooperation with the boycott if so warranted by the facts.

D-2. Q: Who has the burden of proof with respect to establishing whether a particular operation is a "clearly separate and identifiable operation" and whether there was participation in or cooperation with an international boycott in connection with that operation?

A: Where a person or a member of a controlled group has participated in or cooperated with an international boycott in connection with one or more of its operations, that person (or if applicable the U.S. shareholder of a foreign corporation) or that group bears the burden of proof of establishing that any other operation is clearly separate and identifiable from the operation with respect to which participation or cooperation occurred *and* that no such participation or cooperation occurred with respect to the separate and identifiable operation.

D-3. Q: How can a taxpayer determine what constitutes a "clearly separate and identifiable operation"?

A: The determination whether an operation constitutes a clearly separate and identifiable operation must be based on an examination of all the facts and circumstances. The following factors may be considered in determining whether an operation is clearly separate and identifiable from an operation with respect to which participation in or cooperation with an international boycott occurred:

1. Were the two operations conducted by different corporations, partnerships, or other business entities?

2. Were the operations, whether conducted by separate entities or not, supervised by different management personnel?

3. Did the operations involve distinctly different products or services?

4. Were the operations undertaken pursuant to separate and distinct contracts?

5. If business operations in the countries conducting the international boycott in question were not continuous over time, was each transaction separately negotiated and performed?

The application of these factors may be illustrated by the following examples:

(a) Company A contracts with Country X to build several major buildings in Country X. Company A has never engaged in any business in Country X prior to such contract. Nine months later Company A enters into a second contract with Country X to build a large dock facility in Country X. Construction of the dock facility will constitute an operation separate and identifiable from construction of the buildings.

(b) Company A contracts, as general contractor, to build a pipeline in Country X. In connection with the construction of the pipeline, Company A must retain engineering consultants. Company C, a U.S. company and a member of the same controlled group of which Company A is a member, is engaged in the business of providing engineering consulting services to both related and unrelated parties. Company A retains Company C to provide such services with respect to the pipeline construction. The engineering consulting services provided by Company C will constitute an operation separate and identifiable from the construction of the pipeline.

(c) Company A markets electronic computers and medical diagnostic equipment in Country X. The two product lines, computers and medical equipment, are handled by representatives of two separate divisions which are located in different offices. The managers of each division report to different superiors in the United States. The activities of Company A with respect to the sale of computers will constitute a separate and identifiable operation from Company A's activities in connection with the sale of medical equipment.

(d) Company A imports and sells motor vehicles in Country X. Company A maintains a national office and import depot at a major port in Country X and has five sales offices located in various cities in Country X. The managers of the sales offices are authorized to handle local matters relating to maintaining the offices and are subject to the close supervision and inspection of national office personnel. For internal accounting purposes, Company A treats each sales office as a profit center, charging each office for its inventory and a proportional share of corporate overhead. The marketing activities of the various sales offices do not constitute operations separate and identifiable from each other, nor do the marketing activities of Company A as a whole constitute an operation separate and identifiable from the import and distribution activities of Company A.

(e) Company A markets appliances, such as refrigerators, washers and dryers, and home entertainment equipment, such as televisions and tape recorders, in Country X. The appliances are manufactured in Country X by Company C, a U.S. company wholly owned by Company A, and the home entertainment equipment is manufactured in Country X by Company D, also a U.S. company wholly owned by Company A. Company A purchases the production of Company C and Company D for resale to independent retailers who generally handle both lines of products. The board of directors of Companies A, C, and D are composed of the same individuals and the same individual serves as president of each company. The products of Companies C and D are manufactured in the same plant, and the executive offices of Companies A, C, and D are all located in a building adjacent to that plant. The respective activities of Companies A, C, and D do not constitute clearly separate and identifiable operations.

E. *Effective Date Provisions.*

E-1. Q: What are the effective dates of the reporting requirements and sanctions of the international boycott provisions?

A: Generally, the reporting requirements and the sanctions of the international boycott provisions apply to agreements to participate in or cooperate with an international boycott, made after November 3, 1976, and to agreements made on or before November 3, 1976, that continue in effect thereafter. However, there are two exceptions to this general rule. First, the reporting requirements of section 999(a) apply to operations referred to in section 999(a)(1) or (2) after November 3, 1976, whether or not there has been an agreement to participate in or cooperate with an international boycott, and whether or not the operations are carried out in accordance with the terms of a binding contract entered into before September 2, 1976. Operations on or before November 3, 1976, are reportable if there has been participation in or cooperation with the boycott during the taxable year but after November 3, 1976 (see the answer to Question E-2). Second, in the case of operations carried out in accordance with the terms of a binding contract entered into before September 2, 1976, the sanctions of the international boycott provisions apply only to agreements to participate in or cooperate with an international boycott made on or after September 2, 1976, and to agreements made before that date that continue in effect after December 31, 1977.

E-2. Q: If a person who reports his tax liability on a calendar year basis makes an agreement on November 20, 1976, to participate in or cooperate with an international boycott, which of the person's operations conducted during the taxable year are reportable, which operations are included in the international boycott

factor calculations, and how are the sanctions applied?

A: All operations of the person during the entire 1976 taxable year (including pre-November 20, 1976, operations) in or related to a boycotting country or with the government, a company, or a national of such country must be reported under section 999(a) and will be considered in calculating the international boycott factor (or the amount of taxes or income specifically attributable to operations in which there was participation in or cooperation with an international boycott) for the taxable year. However, under section 999(c)(1), operations for which the presumption of participation in or cooperation with the boycott has been rebutted need not be reflected in the numerator of the international boycott factor (or under section 999(c)(2), the tax benefits specifically attributable to specific operations for which that presumption has been rebutted will not be denied).

The sanctions are applied to the year 1976 on a pro rata basis. If a person uses the international boycott factor for 1976, the factor is applied under sections 908, 952(a), and 995(b)(1), after it has been multiplied by the fraction 58/366, representing the number of days after the November 3, 1976, effective date remaining during the calendar year. If a person identifies specifically attributable taxes and income, the tax benefits denied under sections 908, 952(a), and 995(b)(1) are computed by first ascertaining the tax benefits of the foreign tax credit, deferral, and DISC respectively for the taxable year attributable to operations for which the presumption of boycott participation has not been rebutted, and then multiplying that amount by 58/366.

E-3. Q: If a person having a July 1-June 30 taxable year carries out operations in accordance with the terms of a binding contract entered into before September 2, 1976, and, in furtherance of that contract, makes an agreement on February 15, 1978, to participate in or cooperate with an international boycott, which of the person's operations conducted during the taxable year July 1, 1977-June 30, 1978, are reportable, which operations are included in the international boycott factor calculations, and how are the sanctions applied?

A: All operations of the person during the entire July 1, 1977-June 30, 1978, taxable year (including pre-February 15, 1978, operations) in or related to a boycotting country or with the government, a company, or a national of such country, must be reported under section 999(a) and will be considered in calculating the international boycott factor (or the amount of taxes or income specifically attributable to operations in which there was participation in or cooperation with an international boycott) for the taxable year. However, under section 999(c)(1), operations for which the presumption of participation in or cooperation with the boycott has been rebutted need not be reflected in the numerator of the international boycott factor, and, under section 999(c)(2), the tax benefits specifically attributable to specific operations for which that presumption has been rebutted will not be denied.

The sanctions are applied to the July 1, 1977-June 30, 1978, taxable year on a pro rata basis. If a person uses the international boycott factor for the taxable year, the factor is applied under sections 908, 952(a), and 995(b)(1) after it has been multiplied by the fraction 181/365, representing the number of days after the December 31, 1977, effective date remaining during the taxpayer's taxable year. If a person identifies specifically attributable taxes and income, the benefits to be denied under sections 908, 952(a), and 995(b)(1) are computed by first ascertaining the tax benefits of the foreign tax credit, deferral, and DISC respectively for the taxable year attributable to operations for which the presumption of boycott participation has not been rebutted, and then multiplying that amount by 181/365.

E-4. Q: What is a binding contract for purposes of the binding contract rule?

A: A binding contract with respect to a person, a member of a controlled group which includes that person, or a foreign corporation of which that person is a United States shareholder is a contract which was, on September 1, 1976, and is at all times thereafter, binding on that person, foreign corporation or member, and under which all material terms are fixed or are ascertainable with reference to an objectively determinable standard.

E-5. Q: If, under a binding contract existing before September 2, 1976, a person agreed to refrain from an activity described in section 999(b)(3), will operations under the contract be subject to the international boycott provisions in years after 1977?

A: Yes, unless the person establishes that, before December 31, 1977, he renounced the agreement to participate in or cooperate with the boycott, that the renunciation was communicated to the government or person with which the agreement was made, and that the agreement was not reaffirmed after 1977.

E-6. Q: If, under a contract made in 1979, a person who reports his tax liability on a calendar year basis agrees to refrain from an activity described in section 999(b)(3), but does not continue to refrain from such activity after 1980, will operations under the contract be subject to the international boycott provisions in years after 1980?

A: Yes, unless the person establishes that, before December 31, 1980, he renounces the agreement to participate in or cooperate with the boycott, that the renunciation is communicated to the government or person with which the agreement was made, and the agreement is not reaffirmed after 1980.

E-7. Q: If, under a contract made after January 1, 1977, a person agreed to refrain from an activity described in section 999(b)(3), and later renounced the agreement and communicated such renunciation to the government or person with which the agreement was made, which operations of

such person during the taxable year of the renunciation are reportable, which operations are included in the international boycott factor calculations, and how are the sanctions to be applied?

A: All operations of the person during the entire taxable year within which the agreement was renounced (including post-renunciation operations) in or related to a boycotting country or with the government, a company, or a national of such country must be reported under section 999(a) and will be considered in calculating the international boycott factor (or the amount of taxes or income specifically attributable to operations in which there was participation in or cooperation with an international boycott) for the taxable year. However, under section 999(c)(1), operations for which the presumption of participation in or cooperation with the boycott has been rebutted need not be reflected in the numerator of the international boycott factor, and the tax benefits specifically attributable to specific operations for which such presumption has been rebutted will not be denied. There is no proration between the pre-renunciation and post-renunciation portions of the taxable year of either the boycott factor or the specifically attributable taxes and income.

E-8. Q: Before September 2, 1976, Company A enters into a binding contract, which does not contain an agreement to boycott or by itself support an inference of the existence of an agreement to boycott. However, Company A's course of action in carrying out operations in accordance with the terms of the contract constitutes participation in or cooperation with an international boycott. Will the provisions of section 999 be applied to such participation or cooperation which takes place prior to January 1, 1978 (see section 1066(a) of the Tax Reform Act of 1976)?

A: If the course of action from which the existence of the agreement was inferred took place before September 2, 1976, then the provisions of section 999 would not be applied to such participation in or cooperation with an international boycott which takes place prior to January 1, 1978. However, if the inference of the existence of the agreement would depend on action taken on or after September 2, 1976, then the provisions of section 999 would be applied to participation in or cooperation with the international boycott subsequent to November 3, 1976 (see section 1066(a)(1) of the Tax Reform Act of 1976).

F. *International Boycott Factor.*

F-1. Q: How will the international boycott factor be determined?

A: Section 999(c)(1) provides that the international boycott factor will be determined under regulations prescribed by the Secretary. The international boycott factor will be a fraction, the numerator of which reflects the operations of a person (or group) in or related to countries associated in carrying out the international boycott and the denominator of which reflects the person's (or group's) worldwide foreign operations. It is anticipated that regulations setting forth the method of determining the international boycott factor will be forthcoming in the near future and will provide that the international boycott factor will be determined with reference to three factors: purchases, sales, and payroll.

F-2. Q: In the case of a controlled group (within the meaning of section 993(a)(3)), is a single international boycott factor computed for the entire group?

A: Yes. All members of a controlled group share a single, common international boycott factor which reflects the operations of all members of the controlled group.

F-3. Q: Once an international boycott factor has been computed for a controlled group (within the meaning of section 993(a)(3)), how is the factor applied to individual members of the group?

A: The international boycott factor of a controlled group is applied separately under sections 908(a), 952(a), and 995(b)(1) to each individual member of the controlled group.

F-4. Q: If a person applies the international boycott factor to some operations during the taxable year, must the factor be applied to all operations of that person for the taxable year?

A: Yes. If a person applies the international boycott factor to one operation during the taxable year, the factor must be applied to all operations during the taxable year, under each of sections 908(a), 952(a), and 995(b)(1). If a person identifies specifically attributable taxes and income under section 999(c)(2), that method must be applied to all operations during this taxable year and applied under sections 908(a), 952(a), and 995(b)(1).

F-5. Q: In the case of a controlled group (within the meaning of section 993(a)(3)), may one member use the international boycott factor under section 999(c)(1) and another member identify specifically attributable taxes and income under section 999(c)(2)?

A: Yes. Each member may independently choose either to apply the international boycott factor under section 999(c)(1) or to identify specifically attributable taxes and income under section 999(c)(2).

G. *Determinations.*

G-1. Q: What degree of confidentiality will determinations, and requests for determinations, under section 999(d) receive?

A: A determination under section 999(d) will be treated as a "written determination" within the meaning of section 6110(b)(1). Therefore the determination and any background file document related thereto will be subject to public inspection in accordance with the rules set forth in section 6110, and subject to the deletions set forth in section 6110(c).

H. *Definition of an Agreement to Participate in or Cooperate with a Boycott (section 999(b)(3)).*

H-1. Q: Company A, a trading

company, signs a contract with Country X to export goods to Country X. The contract contains a clause requiring Company A not to obtain any of the goods from any company listed in the clause as trading in Country Y. Does Company A's entering into the contract constitute an agreement according to section 999(b)(3)?

A: Yes. Entering into a written contract which includes a provision requiring Company A to refrain from taking an action described in section 999(b)(3)(A)(ii) constitutes an agreement according to section 999(b)(3).

H-2. Q: During the course of negotiations concerning a contract for the export of goods to Country X, Company A, a trading company, and Country X agree orally that Company A will refrain from purchasing any of the goods from any company included on a list shown to Company A's representatives and engaged in trade in Country Y. They also agree that this agreement will not be reflected in the written contract for the export of the goods or in any other writing. Does the oral understanding between Company A and Country X constitute an agreement according to section 999(b)(3)?

A: Yes. The oral understanding is an explicit agreement to refrain from taking an action described in section 999(b)(3)(A)(ii) and thus constitutes an agreement according to section 999(b)(3).

H-3. Q: Company A signs a contract with Country X to construct an industrial plant in Country X. The contract states that the laws, regulations, requirements or administrative practices of Country X will apply to Company A's performance of the contract in Country X. The customs laws, regulations, requirements or administrative practices of Country X prohibit the importation into Country X of goods manufactured by any company engaged in trade in Country Y or with the government, companies or nationals of Country Y. Does Company A's action constitute an agreement according to section 999(b)(3)?

A: No. The existence of an agreement will not be inferred solely from the inclusion in a contract of a provision stating that the laws, regulations, requirements or administrative practices of a country will apply to the performance of the contract in that country.

H-4. Q: The facts are the same as those in Question H-3, except that the contract states that Company A will comply with the laws, regulations, requirements or administrative practices of Country X in its performance of the contract in Country X. Does Company A's action constitute an agreement according to section 999(b)(3)?

A: Yes. Entering into a contract which requires compliance with the laws, regulations, requirements, or administrative practices of Country X constitutes an agreement according to section 999(b)(3), if some of those laws prohibit the importation into Country X of goods manufactured by any company engaged in trade in Country Y or with the government, companies or nationals of Country Y.

H-5. Q: Company A, a trading company, signs a contract with Country X to export goods to Country X. The contract contains no clause concerning a boycott, nor does it require the contractor to comply with the laws, regulations, requirements or administrative practices in Country X, which, among other things, prohibit the importation into Country X of goods manufactured by persons engaged in trade in Country Y. Company A refrains from purchasing any goods with which to fulfill its obligations under the contract from any U.S. company engaged in trade in Country Y or with the government, companies or nationals of Country Y. Does Company A's action constitute an agreement according to section 999(b)(3)?

A: No. Where there is no express agreement, the existence of an agreement will not be inferred solely from the fact that Company A has refrained, consistently with the laws, regulations, requirements or administrative practices of Country X, from purchasing goods with which to fulfill its obligations under the contract from any U.S. company engaged in trade in Country Y or with the government, companies or nationals of Country Y.

H-6. Q: Questions and Answers H-1, H-2, H-4, and H-5 all involve contracts for the export of goods by Company A to Country X and Company A's refraining from doing certain business with United States companies which are blacklisted by Country X because they engage in trade with Country Y. The problem of whether an agreement existed for purposes of section 999(b)(3) would be resolved in the same way as in each of the Answers above were the contract for (a) the supply of services; or (b) a construction project in Country X and Company A refrains from doing business with Country Y, or refrains from doing business with United States companies which are blacklisted by Country X because they engage in trade in Country Y or with the government, companies or nationals of Country Y.

H-7. Q: (a) Company A incorporates a subsidiary in Country X. In the documents submitted by Company A relating to the incorporation of the subsidiary there is a general acknowledgement that the subsidiary is subject to the laws, rules, regulations and administrative practices of Country X.

(b) Company A establishes a branch in Country X. In the documents relating to its registration of the branch there is a general acknowledgement that the laws, rules, regulations and administrative practices of Country X apply to the branch.

Included in the laws, regulations, requirements or administrative practices of Country X is a requirement that companies incorporated in Country X and branches registered in Country X refrain from doing business with any person engaged in trade in Country Y. Does either the acknowledgement of the subsidiary or the undertaking of the branch constitute

an agreement by Company A for purposes of section 999(b)(3)?

A: No as to both the subsidiary and the branch. The mere acknowledgement in incorporation or registration documents of the general applicability of the laws of a boycotting country will not support the inference of the existence of an agreement under section 999(b)(3). However, if in either instance, there was an undertaking to comply with the laws of that country, it would constitute an agreement under section 999(b)(3).

H-8. Q: Company A, a trading company, signs a contract with Country X to export goods to Country X. The contract contains no clause concerning a boycott, nor does it require the contract to be carried out in accordance with the laws, regulations, requirements or administrative practices of Country X, which prohibit the importation into Country X of goods manufactured by persons engaged in trade with Country Y. At the time it exports the goods from the United States, Company A provides Country X (or the U.S. bank which confirms the letter of credit under which Company A is to be paid for the goods and which requires such certificate as a condition of payment) with a certificate that the goods were not manufactured by a person engaged in trade in Country Y or with the government, companies or nationals of Country Y. Should the existence of an agreement for purposes of section 999(b)(3) be inferred from Company A's furnishing the certificate?

A: No. The existence of an agreement will not be inferred solely from the fact that Company A has furnished a certificate to the effect that the goods it is exporting were not manufactured by a person engaged in trade in Country Y or with the government, companies or nationals of Country Y.

H-9. Q: Company A signs a contract with Country X to carry out a construction project in Country X. The contract says nothing about the nationality, race or religion of the individuals who are to be employed to carry out the contract within Country X. However, Company A is aware that the laws, regulations, requirements or administrative practices of Country X may prohibit the issuance of visas by Country X to individuals of religion R to work on projects in that country. Therefore Company A excludes from consideration the employment of individuals of that religion to work on the project in Country X. Does Company A's action constitute an agreement according to section 999(b)(3)?

A: Yes. While Company A has not explicitly entered into an agreement to refrain from employing individuals who are of religion R, the existence of such an agreement will be inferred from its course of conduct. This agreement would constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iv).

H-10. Q: Company A signs a contract for a construction project with Country X. The contract says *nothing* about the nationality, race or religion of the individuals who are to be employed to carry out the contract within Country X. However, Company A is aware that the laws, regulations, requirements or administrative practices of Country X may prohibit the issuance of visas to individuals of religion R. Company A in recruiting people for the project informs all applicants that if they cannot obtain a visa to enter Country X, their employment will be terminated. It employs several individuals of religion R who are unsuccessful in obtaining visas and who are subsequently terminated. Does Company A's action constitute an agreement according to section 999(b)(3)?

A: No. Company A has not refrained from employing individuals of religion R for the project. The existence of an agreement to refrain from employing individuals of religion R will not be inferred from Company A's action.

H-11. Q: The facts are the same as those in Question H-10, except that Company A makes its employment contracts with all individuals for work on the project subject to the condition that they obtain visas from Country X which will permit them to work in Country X. Few, if any, individuals of religion R to whom Company A offers employment in Country X are successful in obtaining visas. Does such action by Company A constitute an agreement according to section 999(b)(3)?

A: No. Company A has offered employment to all individuals who are able to obtain visas. If an individual is unable to obtain a visa, it is due to the requirements of Country X. The existence of an agreement by Company A will not be inferred from Company A's action.

H-12. Q: The facts are the same as those in Question H-10, except that no individuals of religion R are willing to accept employment on the terms offered by Company A. Does such action by Company A constitute an agreement according to section 999(b)(3)?

A: No, for the reasons given in Answer H-10.

H-13. Q: Company A signs a contract with Country X to carry out a construction project in Country X. The contract says nothing about who may or may not be a subcontractor to do certain work in Country X other than that Country X has the right to prior approval of any subcontractors. Does Company A's action constitute an agreement according to section 999(b)(3)?

A: No. The contract provision giving the project owner a right of prior approval does not itself constitute an agreement according to section 999(b)(3).

H-14. Q: Company A signs a contract with Country X to carry out a construction project in Country X. The contract specifies a number of permissible subcontractors. All the subcontractors, in the view of Company A, are capable of carrying out work, but none of them appears on a

list of U.S. and foreign companies which engage in trade in Country Y and which Country X's laws, regulations, requirements or administrative practices prohibit from working on projects in Country X. Company A has previously done business with each of the specified companies, but it has also done business with certain of the boycotted U.S. companies with which it has had satisfactory relations. Does Company A's action constitute an agreement according to section 999 (b) (3)?

A: By entering into a contract which on its face indicates a pattern of exclusion of certain companies including U.S. companies with which Company A has no particular reason not to do business, it would appear that Company A has agreed to refrain from doing business with the boycotted U.S. companies, unless Company A is able to show that the boycotted U.S. companies were not included on the list for reasons not related to the boycott.

H-15. Q: Company A signs a contract with Country X to carry out a construction project in Country X. The contract provides that Country X is to engage all the subcontractors which are to be engaged from outside Country X but which are to perform all or part of their services in Country X. Company A, however, is given the right to disapprove any company which Country X proposes to engage for a subcontract. While the contract is being carried out, none of the companies which Country X proposes to prequalify for invite to bid are included on a list of U.S. companies which engage in trade in Country Y and which are therefore prohibited by Country X's laws, regulations, requirements or administrative practices from working on projects in Country X. Does Company A's action constitute an agreement according to section 999 (b) (3)?

A: No. Under the language of the contract, Company A has not agreed to refrain from doing business with companies which are on the list of prohibited companies. The contract moreover does not give Company A the right to select subcontractors other than those nominated by Country X. Therefore, Company A's action does not constitute an agreement according to section 999(b) (3).

H-16. Q: Company A signs a contract for a construction project with Country X. The contract states that any disputes arising under the contract will be resolved in accordance with Country X's laws. The laws of Country X contain boycott provisions. Does Company A's action constitute an agreement according to section 999(b) (3)?

A: No. The provision that disputes will be resolved in accordance with Country X's laws does not constitute Company A's agreement to comply with Country X's boycott laws with respect to the carrying out of the contract.

H-17. Q: Company A receives an inquiry from Country X about certain goods which Company A manufactures. The inquiry also requests Company A to furnish information about the following matters: whether it does business with Country Y and whether it does business with any United States person engaged in trade in Country Y. Company A furnishes the requested information to Country X. Later Company A signs a contract with Country X to export goods to Country X. Does Company A's action constitute an agreement according to section 999(b) (3)?

A: No. By furnishing such information Company A has not agreed to take any action, as a condition of doing business with Country X, which is described in section 999(b) (3).

H-18. Q: Company A, a trading company, signs a contract with Country X to export goods to Country X. The contract contains a clause requiring Company A not to obtain any of the goods from any company listed in the clause as trading in Country Y. Company A, however, purchases some of the goods from one of the listed companies. Does Company A's entering into this contract constitute an agreement according to section 999 (b) (3)?

A: Yes. Entering into a written contract which includes a provision requiring Company A to refrain from taking an action described in section 999(b) (3) (A) (ii) constitutes an agreement according to section 999 (b) (3), even if Company A, fully or partially, does not abide by the boycott provisions.

H-19. Q: Company A signs a contract with Country X to export goods to Country X. Included in the contract is a provision that Company A will refrain from doing business with Country Y, which is boycotted by Country X. Company A has done considerable business with Country Y in the past, but soon after it concludes that contract with Country X its distributor in Country Y learning of the contract with Country X refuses to continue to handle Company A's products and Company A tries but is unable to conclude any other satisfactory distribution arrangement in Country Y. Does Company A's entering into this contract constitute an agreement according to section 999(b) (3)?

A: Yes, for the reasons given in Answer H-18.

H-20. Q: Company A has been unable to do business with Country X because Company A has been on a blacklist of companies maintained by an organization of countries to which Country X belongs. Company A agrees, as a condition of being removed from the list, to refrain from doing business with Country Y. Does Company A's agreement constitute an agreement according to section 999 (b) (3)?

A: Yes. Even though Company A has not yet entered into a contract to do business with any boycotting country, it has agreed, as a condition for being in a position to do business with one or more of the countries maintaining the blacklist, to refrain from doing business with Country Y. This action constitutes an agreement according to section 999(b) (3).

H-21. Q: The facts are the same as those in Question H-20, except that

Company A does several different types of business with Country Y. It is requested and agrees to refrain from doing only one of those types of business with Country Y and in fact continues to do the other types of business with Country Y. Does Company A's agreement constitute an agreement according to section 999(b)(3)?

A: Yes. An agreement to refrain from some, but not all, business with a boycotted country constitutes an agreement according to section 999 (b)(3). Answer H-20 is also relevant in this context.

H-22. Q: Company A is doing business in Country X. It contracts with Company C which is not related to Company A, for Company C to build an office building for Company A's use in Country X. In the course of constructing the building, Company C participates in or cooperates with a boycott imposed by Country X. Does Company A's actions constitute an agreement according to section 999(b)(3)?

A: Unless Company A specifically directs or requires Company C to take specific action which constitutes participation in or cooperation with the boycott by Company C, Company C's action will not be attributable to Company A under section 999(b)(3), and Company A will not be deemed to be participating in or cooperating with an international boycott.

H-23. Q: Company A signs a contract with Country X for the export of goods to Country X. The contract does not contain any provisions as to which ships should be used for shipping the goods to Country X. The laws, regulations, requirements, or administrative practices of Country X do not permit the importation of goods aboard a ship owned by companies which trade in Country Y. Company A is aware of this requirement and ships the goods on the ships of a company which does not trade in Country Y. Does Company A's action constitute an agreement according to section 999(b)(3)?

A: No, for the reasons given in Answer H-5.

H-24. Q: Company A is competing for an industrial plant construction contract for which Country X is inviting international tenders. The tender documents contain a provision to the effect that Country X will not enter into the contract unless the successful tenderer certifies that in carrying out the contract it will refrain from doing business with a certain list of companies, including some U.S. companies, which do business with Country Y. Company A does not win the tendering, but in its tender it has indicated that it will sign a contract, in the form indicated in the tender documents, and has given Country X a tender bond to that effect. Does Company A's action constitute an agreement according to section 999 (b)(3)?

A: No. Since its offer was not accepted, Company A has not entered into any agreement to refrain from doing business with the blacklisted companies which would constitute participation in or cooperation with an international boycott.

H-25. Q: Company A successfully prequalifies to tender for a contract for the construction of an industrial plant which will be owned by Country X. At the time it attempts to prequalify, Company A is required to state that it understands that the successful tenderer for the contract will have to agree not to do business in connection with the project with any blacklisted U.S. company or with the government, companies or nationals of Country Y. After it prequalifies, Company A decides not to tender for the contract. Does Company A's action constitute an agreement according to section 999(b)(3)?

A: No. Company A has not entered into an agreement to refrain from doing business with the blacklisted companies which would constitute participation in or cooperation with an international boycott.

H-26. Q: Company A competes for an industrial plant construction contract for which Country X is inviting international tenders. The tender documents contain a provision to the effect that Country X will not enter into a contract unless the successful tenderer certifies that in carrying out the contract it will refrain from doing business with any blacklisted U.S. company. Many companies on the blacklist are boycotted by Country X because they trade in Country Y or with the government, companies or nationals of Country Y. Company A wins the tender and successfully convinces Country X that the boycott clause can be deleted from the final contract since Company A had never dealt with any of the blacklisted companies and there is no commercial reason for it to do so in carrying out this particular contract. Does Company A's action constitute an agreement according to section 999(b)(3)?

A: Yes. Company A's assurance to Country X that it will refrain from doing business with the boycotted U.S. companies constitutes an agreement which is a participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii).

H-27. Q: Company A charters a vessel to Company C to be used by Company C in carrying its goods to Country X. Company C, at the request of Company A, agrees in the charter agreement not to take any action wtih respect to, or issue any orders to, the vessel which would result in limiting the vessel's ability to call at ports in Country X and/or subject the vessel to arrest or confiscation in Country X. Does the action of Company A and Company C constitute participation in or cooperation with an international boycott according to section 999(b)(3)?

A: No. In the agreement, Company A and Company C have not agreed to refrain from taking any of the actions enumerated in section 999 (b)(3). Therefore, such action by Company A and Company C does not constitute participation in or cooperation with an international boycott, according to section 999(b)(3).

H-28. Q: Company A charters a vessel to Company C to be used by Company C in carrying its goods to or

from specifically named ports, or a range of ports within a specified geographical area. Company A and Company C agree on a charter agreement which would, in effect, exclude trade by that vessel to a number of countries, including Country Y. Does the action of Company A and Company C constitute participation in or cooperation with an international boycott under section 999(b)(3)?

A: No, for the reasons given in Answer H-27 above.

H-29. Q: Company A signs a contract with Country X for the export of goods to Country X. The contract provides that Company A will not trade in Country Y, and that payment will be made by means of a letter of credit confirmed by Bank B in the United States. The contract requires Company A to provide to Bank B a certificate that it has complied with the boycott requirements before it can be paid by Bank B. Bank B confirms the letter of credit and later makes payment to Company A after determining that all documents, including the boycott certificate, are in order. Does Bank B's action constitute participation in or cooperation with an international boycott under section 999(b)(3)?

A: No. Bank B's action does not constitute an agreement by it to refrain from any of the types of activities listed in section 999(b)(3)(A). Therefore it does not constitute participation in or cooperation with an international boycott by Bank B. (Company A's action does constitute participation in or cooperation with an international boycott by Company A according to section 999(b)(3)(A)(i).)

H-30. Q: Company A signs a contract with Country X for the supply of goods. The contract provides that Company A will not trade with Country Y, and that payment will be made by means of a letter of credit confirmed by Bank B in the United States provided that Bank B certifies to Country X that it will not confirm letters of credit relating to the export of goods to Country Y. Bank B confirms the letter of credit, after issuing the requested certificate. Does Bank B's action constitute participation in or cooperation with an international boycott under section 999(b)(3)?

A: Yes. Bank B has agreed to refrain from doing business with or in Country Y or with the government, companies or nationals of that country. This action constitutes participation in or cooperation with an international boycott according to section 999(b)(3)(A)(i).

I. *Refraining from Doing Business with or in a Boycotted Country (section 999(b)(3)(A)(i)).*

I-1. Q: Company A signs a contract with Country X for the export of certain goods to Country X. In that contract there is a provision that none of the goods to be provided thereunder shall come from Country Y. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: No. Company A in entering into such a contract is complying with the prohibition by Country X on the importation of goods produced in whole or in part in any country which is the object of an international boycott. Such action, according to section 999(b)(4)(B), does not constitute participation in or cooperation with an international boycott.

I-2. Q: Company A owns a number of ships. It understands that if one of its ships visits Country Y, that ship will thereafter be unable to visit Country X. Company A has some ships which visit Country Y but not Country X and other ships which visit Country X but not Country Y. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: No. Company A has not refrained from doing business with Country Y as some of its ships are still calling there. Therefore Company A's action does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(i).

I-3. Q: Company A signs a contract with Country X, licensing a company in Country X to use certain of its patents and trademarks in Country X. The contract provides that Company A will not enter into an agreement with respect to the use in Country X of patents and trademarks with any national of Country Y. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: Yes. Company A has agreed to refrain from doing business with any national of Country Y and such action constitutes participation in or cooperation with an international boycott according to section 999(b)(3)(A)(i).

I-4. Q: Same facts as in Question I-4, except that Company A has a number of other licensing agreements with Country Y and enters into still more such agreements after it signs the contract with Country X. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: Yes, for the same reasons as stated in Answer I-3 above. Answer H-18 is relevant in this context.

I-5. Q: Company A signs a contract with Country X to export some products from Country X. The contract requires Company A to certify that the goods will not be sent to Country Y. Company A so certifies. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: No. Company A's compliance with Country X's prohibition on the exportation of products of Country X to Country Y does not constitute participation in or cooperation with an international boycott, according to section 999(b)(4)(C).

J. *Refraining from Doing Business with any United States Person Engaged in Trade in a Boycotted Country (section 999(b)(3)(A)(ii)).*

J-1. Q: Company A signs a con-

tract with Country X for the turn-key construction of an industrial plant. The contract provides that Company A will not use as subcontractors a number of named U.S. firms whose past performance on contracts in Country X has been unsatisfactory, according to Country X, for reasons unrelated to the boycott. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: No. The exclusion of subcontractors based on their performance is not covered by section 999(b)(3).

J-2. Q: Company A enters into a contract with Country X to export certain goods to Country X. The contract provides that Company A shall not use any goods manufactured by Company B in performing the contract since Company B is blacklisted by Country X even though Company B does not engage in any kind of trade in a country which is the object of the boycott or with the government, companies, or nationals of that country. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: No. Since Company B is not engaged in trade in Country Y or with the government, companies or nationals of Country Y, Company A's agreement to refrain from doing business with Company B does not come within the scope of section 999(b)(3)(A)(ii).

J-3. Q: Company A competes for an industrial plant construction contract for which Company P of Country W is inviting international tenders. The contract is to be financed by Country X, which maintains a blacklist of companies (including some U.S. companies) which engage in trade with Country Y. Many of the companies are on the list because they are engaged in trade in Country Y. Country X requires contracts which it finances to state that the contractor is required to refrain from making any purchases for the project from any of the blacklisted companies. Country W does not boycott those companies. Company A wins the tender and signs the contract with Company P with the blacklist provision. Does Company A's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii)?

A: Yes. Although the boycott is not implemented by Country W, but by Country X, and the project is being carried out in Country W, Company A has agreed not to do business with blacklisted U.S. companies as a condition of doing business with Company P. This action constitutes participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii).

J-4. Q: Company A signs a contract with Country X to export certain goods to Country X. The contract provides that Company A will not do business with any company blacklisted by Country X. Among the blacklisted companies are a number of foreign subsidiaries of U.S. companies, but no U.S. companies are on the list. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: No. According to section 999(b)(3)(A)(ii) refraining from doing business with any United States person engaged in trade in a boycotted country constitutes participation in or cooperation with an international boycott. For purposes of this particular section "United States person" does not include foreign subsidiaries of a United States person.

J-5. Q: Bank B advises Country X on its investments in the United States. Country X instructs Bank B not to recommend for investment any shares of certain companies which are engaged in trade in Country Y. Bank B follows these instructions. Does Bank B's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii)?

A: No. In following the instructions Bank B itself has not agreed to refrain from doing business with a United States person engaged in trade with Country Y. Therefore Bank B's action does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii).

J-6. Q: Bank B manages Country X's investment portfolio in the United States. Bank B has been given certain powers to act for Country X, pursuant to instructions which, among other things, require Bank B not to invest Country X's funds in stocks and bonds issued by certain specific United States companies, some of which are engaged in trade in Country Y. Does Bank B's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii)?

A: No. An agreement to refrain from purchasing stocks or bonds issued by a certain company does not constitute an agreement to refrain from doing business with that company. Accordingly, Bank B's action does not constitute participation in or cooperation with an international boycott, according to section 999(b)(3)(A)(ii).

J-7. Q: Company A signs a contract with Country X to construct an industrial plant in Country X. The laws, regulations, requirements or administrative practices of Country X prohibit the entry into Country X of goods produced by blacklisted companies, many of which trade in Country Y or with the government, companies or nationals of Country Y. The contract states that the laws and regulations of Company X will apply to Company A's performance of the contract in Country X. In carrying out the project, Company A invites bids to furnish all goods and equipment on a delivered-in-Country X basis. No boycotted company on the blacklist maintained by Country X bids. Does Company A's action, as described in this question, constitute participation in or cooperation with an international byocott under section 999(b)(3)(A)(ii)?

A: No. By the terms of the agreement Company A has not agreed to refrain from doing business with any

of the blacklisted companies. The fact that blacklisted companies are unable to meet the conditions which Company A establishes is not due to any agreement by Company A with Country X, but is due to Country X's laws, regulations, requirements or administrative practices.

J-8. Q: The facts are the same as those in Question J-10, except that Company A's purchase contracts require vendors to reimburse Company A for the purchase price and transportation costs, plus interest, of any goods which Company A cannot import into Country X because of Country X's import restrictions. In this case, does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3(A)(ii)?

A: No, for the reasons given in Answer J-10.

J-9. Q: Company A signs a contract with Country X to produce or purchase goods in Country X for export. The contract requires Company A to certify that the goods will not be sent to Country Y and that Company A will require a similar certification by any purchaser of the products if they are substantially unaltered at the time of the resale by Company A. Company A thereafter sells these goods to Company B, requiring a similar certification. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: No. Company A's agreement to refrain, and to require its buyer in the resale to refrain, from sending Country X's unaltered products to Country Y, according to section 999(b)(4)(C), does not constitute participation in or cooperation with an international boycott.

J-10. Q: Company A signs a contract with Country X for the export of goods to Country X. The contract requires Company A, before it receives payment for the goods, to provide Country X with a certificate naming the company which produced the goods. The laws, regulations, requirements or administrative practices of Country X prohibit the importation into Country X of goods manufactured by a company engaged in trade in Country Y or with the government, companies or nationals of Country Y. Does Company A's action constitute an agreement, according to section 999(b)(3)(A)(ii)?

A: No. The existence of an agreement to refrain from doing business with a United States person engaged in trade with Country Y or with the government, companies or nationals of Country Y, will not be inferred solely from the inclusion of a requirement in a contract that Company A provide Country X with a certificate as to the identity of manufacturer of the goods being sold pursuant to the contract.

K. *Refraining from Doing Business with any Company Whose Ownership or Management is Made up, in Whole or in Part, of Individuals of a Particular Nationality, Race or Religion (section 999(b)(3)(A)(iii)).*

K-1. Q: Company A signs a contract with Country X for the export of certain goods to Country X. In the contract it is provided that the goods shall not bear any mark symbolizing Country Y or religion R. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iii)?

A: No. Section 999(b)(3)(A)(iii) concerns refraining from doing business on the basis of the religion of the owners or management of the organization and refraining from employing individuals of a particular religion. It does not concern refusal to allow certain types of religious marks into a country. No part of section 999(b)(3) concerns refusals to purchase goods bearing marks symbolizing a certain country.

K-2. Q: As a condition of doing business in a country, Company A's subsidiary in Country X agrees that the board of directors of the subsidiary must consist of a specified number of nationals of Country X. Does such action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iii)?

A: No. Such action will not be deemed to constitute an agreement to participate in or cooperate with an international boycott according to section 999(b)(3)(A)(iii).

K-3. Q: Company A is the leader of a syndicate of U.S. and foreign banks which is underwriting a public bond issue of Country X. Company C is a member of that syndicate. During the loan negotiations, Country X indicates that Company D, which is not a U.S. company, should be excluded from the syndicate because of the religion of some of its directors. Company A and Company C agree that they did not contemplate that Company D would be a member of the syndicate in any event and that complying with the request of Country X presents no problem. Does the action of Company A and Company C constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iii)?

A: Yes. The action of Company A and Company C is an agreement to refrain from doing business with a company whose management are individuals of a particular religion. According to section 999(b)(3)(A)(iii) this constitutes participation in or cooperation with an international boycott.

K-4. Q: The facts are the same as in Question K-3, except that Country X indicates that Company D may be included only if it removes several of its directors who are of nationality Y. Does the action of Company A and Company C constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iii)?

A: Yes, for the reasons given in Answer K-3 above.

L. *Refraining from Employing Individuals of a Particular Nationality, Race or Religion (section 999(b)(3)(A)(iv)).*

L-1. Q: Company A signs a construction contract with Country X which provides that Company A is

not to employ individuals of religion R to work on the project in Country X. Does such action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iv)?

A: Yes. Company A has clearly agreed to refrain from employing individuals of religion R. Section 999(b)(3)(A)(iv) defines an agreement, made as a condition of doing business with the government of a country, to refrain from employing individuals of a particular religion as participation in or cooperation with an international boycott.

L-2. Q: Company A signs a contract with Country X for a construction project in Country X. The contract specifies that only individuals who are nationals of the United States or Country X will be allowed to work on the project. Would Company A's action constitute participation in or cooperation with an international boycott under section 99(b)(3)(A)(iv)?

A: No. There is no evidence of an attempt to specifically exclude persons of a particular nationality. Persons of a number of different nationalities, including those from both friendly and unfriendly countries, have been even-handedly excluded.

L-3. Q: As a condition of doing business in Country X, Company A agrees to employ a specified percentage of nationals of Country X or to employ increasing numbers of nationals of Country X. Does such action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iv)?

A: No. Such action will not be deemed to constitute an agreement to participate in or cooperate with an international boycott under section 999(b)(3)(A)(iv).

L-4. Q: Company A signs a contract with Country X for the engineering and construction of an industrial plant in Country X. The contract excludes from working in Country X U.S. nationals who are also nationals of Country Y or who were formerly nationals of Country Y. Does Company A's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iv)?

A: Yes. Any agreement to differentiate among U.S. citizens on the basis of dual nationality or national origin for employment on a project constitutes participation in or cooperation with an international boycott, according to section 999(b)(3)(A)(iv).

L-5. Q: Company A signs a contract with Country X for the engineering and construction of an industrial plant in Country X. The contract provides that Company A is not to employ in its home office any individuals who are nationals of Country Y to work on the design of the plant. Does Company A's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iv)?

A: Yes. Company A has agreed to refrain from employing individuals who are nationals of Country Y, and such agreement constitutes participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iv).

M. *As a condition of the sale of a product, refraining from shipping or insuring that product on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott (section 999(b)(3)(B)).*

M-1. Q: Company A enters into a c.i.f. contract for the export of goods to Country X. The contract states that the goods are not to be shipped on a ship blacklisted by Country X. Many of the ships on the list have in the past called at a port in Country Y, contrary to the laws, regulations, requirements or administrative practices of Country X. Does Company A's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(B)?

A: Yes. Company A has agreed as a condition of the sale of its goods, in effect, to refrain from shipping the goods on a carrier owned, leased or operated by a person who does not participate in or cooperate with an international boycott. This action constitutes participation in or cooperation with an international boycott according to section 999(b)(3)(B).

M-2. Q: Company A enters into a f.a.s. Port of New York contract with Country X for the sale of goods to Country X. While no overseas shipping or insurance provisions are contained in the contract, Company A has reason to believe that arrangements will be made by Country X to see that the goods are not shipped on a carrier owned, leased, or operated by a person who does not participate in or cooperate with Country X's boycott of Country Y. Does Company A's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: No. Company A has not agreed as a condition of sale to refrain from shipping on a carrier owned, leased or operated by a person who does not participate in or cooperate with an international boycott. It has not agreed to any shipping or insurance arrangements. Its action thus does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B).

M-3. Q: Company A is requested by Country X to enter into a c.i.f. contract for the export of goods to Country X. However, to avoid participation in or cooperating with an international boycott Company A successfully convinces Country X that the contract should specify shipment f.a.s. Port of New York. The remainder of the circumstances are as described in Question M-2 above. Does Company A's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: No, for the reasons given in Answer M-2.

M-4. Q: Company A, a United States freight forwarding company, has a contract with Country X to make, as an agent of Country X, shipping and insurance arrangements for goods which Country X purchases in the

United States on a f.a.s. Port of New York basis. The contract provides that no shipments will be made on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott. Company A then makes shipping and insurance arrangements on that basis. Does Company A's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: No. Company A's agreement not to make shipping arrangements on a carrier of a person who does not participate in Country X's boycott of Country Y is not made as a condition of the sale of a product which is to be shipped to Country X. Therefore, Company A's action does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B). However, Company A's agreement would constitute participation in or cooperation with an international boycott pursuant to section 999(b)(3)(A)(ii) if there are vessels owned by U.S. persons with which the agreement requires Company A not to deal.

M-5. Q: Company A enters into a contract with Country X for the export of goods to Country X. The contract requires Company A not to ship the goods on a ship owned, controlled, operated, or chartered by Country Y or a national of Country Y or on a ship which during the voyage calls at Country Y enroute from the United States to Country X. There is a state of hostility between Country X and Country Y. Company A complies with this requirement. Does Company A's action constitute participation in or cooperation with an international boycott?

A: No. Company A has not participated in or cooperated with an international boycott. The requirement in the contract constitutes a precautionary measure to avoid risk of confiscation of the goods rather than a restrictive boycott practice.

M-6. Q: Company A enters into a contract with Country X for the export of goods to Country X. The contract requires Company A to ship the goods only on a ship registered in Country X. Does Company A's action constitute participation in or cooperation with an international boycott, according to section 999(b)(3)(B)?

A: No. An agreement to ship the goods only in a ship registered in Country X does not constitute an agreement to refrain from shipping or insuring those goods on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott. Therefore, Company A's action does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B).

M-7. Q: Company A signs a contract with Country X for the export of goods to Country X. The contract provides that the goods may not be shipped on a vessel which has been blacklisted by Country X because it has called at Country Y in the past. Does Company A's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: Yes. The reason for those vessels being blacklisted was that at some time in the past the owner, lessor or operator of the vessel did not comply with the requirement of Country X that the vessel not call at Country Y. Therefore, Company A's signing the contract constitutes participation in or cooperation with an international boycott, according to section 999(b)(3)(B).

M-8. Q: Company A signs a contract with Country X for the export of goods to Country X. The contract contains no requirement that the seller refrain from shipping the goods on a vessel which has been blacklisted by Country X because it has called at Country Y in the past. Company A does not ship the goods on a blacklisted vessel. Does Company A's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: No, an agreement to participate in or cooperate with an international boycott, according to section 999(b)(3)(B), will not be inferred from Company A's action.

M-9. Q: Company A signs a c.i.f. contract with Country X for the export of goods to Country X to be paid for by means of a letter of credit. The letter of credit for this transaction requires, as a condition of payment, Company A to certify as to the identity of the vessel and the identity of the insurer. Company A provides such a certificate to the paying bank. Does Company A's action constitute participation in or cooperation with an international boycott?

A: No, the existence of an agreement to participate in or cooperate with an international boycott will not be inferred solely on the basis of Company A's certification.

WILLIAM E. SIMON,
Secretary of the Treasury.

November 10, 1976.

(Filed by the Office of the Federal Register on November 9, 1976, 11:09 a.m., and published in the issue of the Federal Register for November 11, 1976, 41 F.R. 49923)

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26 CFR 601.201: Rulings and determination letters.

Reorganizations; advance rulings; possible return of stock. Guidelines set forth the operating rules for issuing an advance ruling for a reorganization involving an agreement under which a portion of the stock of the acquiring corporation may be placed in escrow or required to be returned to the corporation under specified conditions; Rev. Proc. 74-26 amplified and Rev. Proc. 75-11 superseded.

Rev. Proc. 76-26

Sec. 3 of Rev. Proc. 74-26, 1974-2 C.B. 478, which provides operating rules pertaining to issuing ruling letters by the Reorganization Branch of the Income Tax Division, now the Corporation Tax Division, is amplified by the addition of the following subsection:

.06 In reorganizations under sections 368(a)(1)(A), (B), and (C) of the Code where the requisite stock or property has been acquired, a portion of the stock of the acquiring corporation, or a corporation in "control" thereof, that is issued in the exchange may be placed in escrow by the exchanging shareholders, or may otherwise be made subject to a condition pursuant to the agreement or plan of reorganization, for possible return to the acquiring corporation under specified conditions provided (1) there is a valid business reason for establishing the arrangement: (2) the stock subject to such arrangement appears as issued and outstanding on the balance sheet of the acquiring corporation and such stock is, in fact, legally outstanding under applicable state law; (3) all dividends paid on such stock will be distributed currently to the exchanging shareholders; (4) all voting rights of such stock (if any) are exercisable by or on behalf of the shareholders or their authorized agent; (5) no shares of such stock are subject to restrictions requiring their return to the issuing corporation because of death, failure to continue employment or similar restrictions; (6) all such stock is released from the arrangement within 5 years from the date of consummation of the reorganization (except where there is a bona fide dispute as to whom the stock should be released to); and (7) at least 50 percent of the number of shares of each class of stock issued initially to the shareholders (exclusive of shares of stock to be issued at a later date as described in .03 above) is not subject to the arrangement.

Rev. Proc. 75-11, 1975-1 C.B. 652, amplifies Rev. Proc. 74-26, by setting forth the same provisions, as above, under which a portion of the stock of an acquiring corporation, or a corporation in control thereof, issued in a reorganization under section 368(a)(1)(A), 368(a)(1)(B), or 368(a)(1)(C) of the Code may be placed in escrow by the exchanging shareholders for possible return to the acquiring corporation.

Rev. Proc. 75-11 is superseded since the provisions set forth therein are restated in this Revenue Procedure, which also makes these provisions applicable to situations where a portion of the stock of an acquiring corporation, or a corporation in control thereof, issued in a reorganization under section 368(a)(1)(A), 368(a)(1)(B), or 368(a)(1)(C) of the Code, is not placed in escrow but is nevertheless required under the terms of the agreement or plan of reorganization to be returned by the shareholders of the acquired corporation to the acquiring corporation under specified circumstances.

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability. (Also Part I, Section 167; 1.167(a)-11.)

Rev. Proc. 76-27[1]

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to prescribe under section 1.167(a)-11 of the Income Tax Regulations a new asset guideline class, asset guideline period, asset depreciation range, and repair allowance percentage for assets used in the liquefaction and regasification of natural gas in liquefied natural gas (LNG) plant facilities. This permits the use of the Class Life Asset Depreciation Range (ADR) system in the determination of depreciation and annual repair allowance for these assets for tax purposes for the new asset guideline class 49.25, Liquefied Natural Gas Plant. This class is established for the assets used in this activity with an appropriate asset guideline period, asset depreciation range, asset guideline repair allowance percentage, and a description of the assets included in the asset guideline class.

The classification of the eligible property under the ADR system is not determinative of the proper classification of LNG property for investment credit purposes under sections 38 and 50 of the Internal Revenue Code. See Rev. Rul. 76-268, page 7, this Bulletin.

SEC. 2. ASSET GUIDELINE CLASS AND PERIOD, ASSET DEPRECIATION RANGE AND ASSET GUIDELINE REPAIR ALLOWANCE FOR LIQUEFIED NATURAL GAS (LNG).

For class 49.25, the asset guideline class, asset guideline period, asset depreciation range, asset guideline repair allowance percentage, as prescribed, are set forth below.

[1] Also released as IR-1628, dated June 25, 1976.

Asset Guideline Class	Description of Assets Included	Lower Limit	Asset Guideline Period	Upper Limit	Annual Asset Guideline Repair Allowance Percentage
49.25	Liquefied natural gas plant: Includes assets used in the liquefaction, storage, and regasification of natural gas including loading and unloading connections, instrumentation equipment and controls, pumps, vaporizers and odorizers, tanks, and related land improvements. Also includes pipeline interconnections with gas transmission lines and distribution systems and marine terminal facilities ----------	17.5	22	26.5	4.5

SEC. 3. EFFECT ON OTHER DOCUMENTS.

Rev. Proc. 72-10, 1972-1 C.B. 721, is modified by the supplemental asset guideline class set forth in section 2 above with prescribed asset guideline period and depreciation range, and the annual asset guideline repair allowance percentage as indicated.

SEC. 4. EFFECTIVE DATE.

The asset guideline classes, periods, asset depreciation ranges, and annual repair allowance percentages for liquefied natural gas activities set forth in this Revenue Procedure are effective for property placed in service during taxable years beginning on or after January 1, 1975.

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26 CFR 601.204: Changes in accounting periods and in methods of accounting. (Also Part I, Sections 471, 472; 1.471-2, 1.472-2.)

Rev. Proc. 76-28[1]

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to set forth the application of section 1.471-2 of the Income Tax Regulations, concerning inventory write-downs, including subnormal goods under section 1.471-2(c), to the use of the last-in, first-out ("LIFO") inventory method as described in section 472 of the Internal Revenue Code of 1954.

SEC. 2. SCOPE.

This Revenue Procedure applies to taxpayers who have elected (or extended) the LIFO inventory method and either excluded "goods written down" under section 1.471-2 of the regulations from their LIFO election (or extensions) or included such goods in their election (or extensions) at a value less than cost. In addition, this Revenue Procedure applies to taxpayers, who after electing (or extending) the LIFO inventory method, have written down the carrying value of such goods in their closing LIFO inventory to less than cost for any year subsequent to the year of the LIFO election (or extension). For these purposes, cost means actual cost. This procedure also provides guidelines for the treatment of goods written down by taxpayers who elect (or extend) the LIFO inventory method in the future.

SEC. 3. BACKGROUND.

.01 Section 471 of the Code provides general rules for the use of inventories. Section 1.471-2(a) of the regulations provides that each inventory: (1) must conform as nearly as may be to the best accounting practice in the trade or business, and (2) must clearly reflect income. Section 1.471-2 (b) provides, in part, that inventory rules cannot be uniform but must give effect to trade customs that come within the scope of the best accounting practice in the particular trade or business. Further, in order to clearly reflect income, the inventory practice should be consistent from year to year. Section 1.471-2(c) deals with the valuation of inventories, and states that the bases of valuation most commonly used to meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. However, any goods in an inventory that are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether cost or market, whichever is lower, is used.

.02 Subject to approval by the Commissioner of Internal Revenue, section 472 of the Code allows a taxpayer to elect to use the LIFO method of identifying items in the closing inventory for goods specified in the application for such approval.

.03 Section 472(b)(2) of the Code states that in inventorying goods specified in the application to elect LIFO, the taxpayer shall inventory such goods at cost.

.04 Section 472(d) of the Code provides, in part, that in determining income for the taxable year preceding the taxable year for which the LIFO method is first used, the closing inventory of such preceding year of the goods specified in the application shall be at cost.

.05 Section 1.472-2(c) of the regulations provides that goods of the specified type included in the opening inventory of the taxable year for which the method is first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the prior taxable year with the exception that restoration shall be made with respect to any write-down to market values resulting from the pricing of former inventories.

.06 Section 1.472-4 of the regulations states that a taxpayer may not change to the LIFO method unless, at the time the taxpayer files its application for the adoption of such method, it agrees to such adjustments incident to the change to or use of such method, in the inventories of prior taxable years or otherwise, as the district director, upon examination of the taxpayer's returns, deems necessary in order to clearly reflect income.

.07 Rev. Rul. 76-282, page 137, this Bulletin, holds that for purposes of section 1.472-2 of the regulations, the taxpayer's right to select the class or classes of goods to be covered by the LIFO election (or extension) goes to the nature of the goods and not to their condition, salability or other characteristics. Therefore, when the LIFO method is elected (or extended) for a particular class of goods, the election must include all goods within that class regardless of whether they are normal goods or goods that are unsalable at normal prices or unusable in the normal way. It further holds that the adjustment required under section 472(d) of the Code must include any write-down from actual cost with respect to goods that are unsalable at

[1] Also released as News Release IR-1630, dated July 2, 1976.

normal prices or unusable in the normal way, as well as normal goods that have been written down to market value under section 1.471-4.

SEC. 4. APPLICATION.

.01 The provisions of section 1.471-2 of the regulations, as they would relate to inventory write-downs, are not applicable for purposes of section 472 of the Code. Furthermore, a write-down in inventory valuation under section 1.471-2(c) relating to the valuation of subnormal goods does not create a separate class of goods.

.02 Solely for purposes of this Revenue Procedure so-called "excess stock" write-downs and percentage write-downs applied to a class or type of goods will be considered as coming within the write-down restoration rules contained herein pertaining to section 1.471-2 of the regulations.

.03 When the LIFO inventory method is elected for a particular class of goods, the LIFO method is to be applied to all goods within that class of goods, including those that may be unsalable at normal prices or unsalable in the normal way. Within a given class of goods the LIFO method makes no distinction between goods that have been written down and those that have not been written down.

.04 Section 472(b) of the Code requires that under the LIFO inventory method, the inventory shall be taken at cost for the year of the LIFO election, as well as subsequent taxable years.

.05 In order to properly satisfy the requirements of section 472(d) of the Code, regarding the value of the closing inventory of the year preceding the year of the LIFO election (or extension), such closing inventory must be valued at actual cost. In order to value such closing inventory at actual cost, any write-down in inventory value determined under section 1.471-2 of the regulations including those made to reflect unsalability at normal prices or unusability in the normal way that was reflected in the closing inventory of the year preceding the year of the LIFO election (or extension) must be restored when the LIFO method is elected (or extended).

.06 If the closing inventory of the year preceding the year of the LIFO election (or extension) is not valued at cost, an amended Federal income tax return must be filed for such preceding year to properly state such inventory at cost. The amended return, with respect to the taxable year preceding the taxable year for which the LIFO inventory method is elected (or extended) must be filed with the Federal income tax return for the taxable year for which the LIFO inventory method is elected (or extended). Any adjustment necessary in order to restate the preceding year's ending inventory at cost as required by section 472(d) of the Code, to the full extent thereof, must be taken into account and reflected in the income of the amended return for the preceding taxable year. See Rev. Proc. 76-6, 1976-1 C.B. 545, as revised by Announcement 76-38, 1976-13 I.R.B. 21 (IR-1576), Announcement 76-78, 1976-24 I.R.B. 44 (IR-1613), and Announcement 76-95, I.R.B. 1976-30.

.07 Once the LIFO election has been made with respect to a particular class of goods, inventories of like goods shall be taken at cost regardless of market value, any determination as to unsalability at normal prices or unusability in the normal way or any other write-down made pursuant to section 1.471-2 of the regulations.

.08 With respect to a taxpayer that has a LIFO election in effect for a taxable year(s) prior to the effective date contained in section 6, this Revenue Procedure will not apply to goods disposed of prior to the beginning of the first taxable year commencing on and after 60 days from July 26, 1976, the date of publication of this Revenue Procedure in Internal Revenue Bulletin 1976-30, whose carrying value has been determined by reference to section 1.471-2 of the regulations. If a taxpayer has on hand at the beginning of the first taxable year commencing 60 days after July 26, 1976, goods whose carrying value has been determined by reference to section 1.471-2, such goods must be valued at cost as of the end of the preceding taxable year to the extent such restoration has not been previously made.

.09 Any restoration of a write-down to market value for purposes of section 472(d) of the Code must be made in accordance with the provisions of Rev. Proc. 76-6, as revised, with respect to any goods whose carrying value has been determined under section 1.471-4 of the regulations.

.10 If a taxpayer has elected (or extended) the LIFO inventory method and fails to comply with the provisions of this Revenue Procedure, the Service, upon examination of such taxpayer's Federal income tax return, may require the taxpayer to discontinue the LIFO inventory method.

SEC. 5. INQUIRIES.

Inquiries regarding this Revenue Procedure may be addressed to the Commissioner of Internal Revenue, Attention: T:C:C, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

SEC. 6. EFFECTIVE DATE.

This Revenue Procedure, except for the provisions of section 4.09, is applicable for taxable years beginning on and after 60 days from July 26, 1976, the date of the publication of this Revenue Procedure in Internal Revenue Bulletin 1976-30.

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 76-29

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to announce that the test program announced in Rev. Proc. 75-23, 1975-1 C.B. 719, with respect to the processing of certain ruling requests, is adopted as a permanent change.

SEC. 2. BACKGROUND.

Rev. Proc. 74-19, 1974-2 C.B. 465, as modified by Rev. Proc. 75-1, 1975-1 C.B. 642, announced a program under which two Branches in the office of

the Assistant Commissioner (Technical), on a test basis, would contact taxpayers or their authorized representatives within 7 work days. This test program expired on January 1, 1975, but was extended to March 31, 1975, by Rev. Proc. 75-1. Rev. Proc. 75-23 announced a further expansion and extension, on a test basis, of the ruling procedure set forth in Rev. Proc. 74-19. Under this further expansion and extension Service personnel, within 15 work days after receipt in the Branch, contact the taxpayer or, if designated, the taxpayer's authorized representative, to discuss informally the procedural and substantive issues involved in the ruling requests. Rev. Proc. 75-23 expired July 1, 1976.

SEC. 3. SCOPE.

This permanent procedure will cover original ruling requests received on or after July 1, 1976, that meet the requirements set forth in Section 6 of Rev. Proc. 72-3, 1972-1 C.B. 698. The following subject matters will be included:

(1) Individual Income Tax Branch

(a) Partnerships and trusts

(b) Code section 103

(c) Real estate investment trusts

(d) Stock options

(e) Charitable remainder trusts

(f) Pooled income funds

(2) All matters within the jurisdiction of the Corporation Tax Branch except cases

(a) involving a request for change in accounting methods or periods,

(b) relating to the last-in first-out method of computing inventory,

(c) insurance issues involving contracts with reserves based on segregated asset accounts,

(d) insurance issues requiring actuarial computations.

(3) All matters within the jurisdiction of the Wage, Excise and Administrative Provisions Branch, except ruling requests from individuals for employment status submitted on Forms SS-8.

(4) All matters within the jurisdiction of the Engineering and Valuation Branch, Reorganization Branch, and Estate and Gift Tax Branch.

SEC. 4. PROCEDURES TO BE FOLLOWED REGARDING RULING REQUESTS RECEIVED ON OR AFTER JULY 1, 1976.

.01 Within 15 work days after an original ruling request has been received in the Branch, a representative of the Branch will contact the taxpayer or the authorized representative to discuss the procedural and substantive issues involved in the ruling requests covered by this procedure. As to each issue coming within the jurisdiction of the Branch, the Branch representative will inform the taxpayer or the authorized representative:

(1) whether the Branch representative will recommend the Service rule as requested by the taxpayer, rule adversely on the matter, or not rule;

(2) whether the taxpayer should submit additional information or representations to enable the Service to rule on the matter; and/or

(3) whether, because of the nature of the transaction, or the issue presented, a tentative conclusion on the issue cannot be reached.

.02 Where the rulings requested involve matters within the jurisdiction of more than one Branch and/or within the jurisdiction of more than one office within the same Branch, a representative of the Branch that received the original ruling request will inform the taxpayer or the authorized representative, within the initial 15 work day contact period, that the rulings requested involving matters within the jurisdiction of another Branch and/or within the jurisdiction of more than one office within the same Branch and covered by this procedure, have been referred to that Branch or office for consideration and that a representative of that Branch or office will contact the taxpayer or the authorized representative within 15 work days of the receipt by that Branch or office of the referral to informally discuss the procedural and substantive issues involved in the matters referred to that Branch or office.

.03 If something less than a fully favorable ruling is indicated with respect to a proposed transaction, the Branch representative will inform the taxpayer or the authorized representative whether, in the Branch representative's opinion, such transaction might be modified so as to warrant issuance of a favorable ruling. If, at the conclusion of the discussion, the Branch representative determines that a meeting in the National Office would better serve the purpose of developing or exchanging information, such a meeting will be offered and an early meeting date arranged. Any such meeting will not constitute the taxpayer's conference of right as described in Section 7.02 of Rev. Proc. 72-3.

.04 The Service will not be bound by the informal opinion expressed by the Branch representative or any other authorized Service representative under this procedure, and such opinion cannot be relied upon as a basis for granting retroactive relief under the provisions of section 7805(b) of the Internal Revenue Code.

.05 The ruling request will thereafter be processed under existing procedures.

SEC. 5. EFFECTIVE DATE.

This Revenue Procedure is effective July 1, 1976.

SEC. 6. EFFECT ON OTHER DOCUMENTS.

Rev. Proc. 74-19, Rev. Proc. 75-1, and Rev. Proc. 75-23 are obsolete.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 38, 61, 162, 167; 1.38-1, 1.61-1, 1.162-1, 1.167(a)-1.)

Rev. Proc. 76-30 [1]

SECTION 1. PURPOSE.

This Revenue Procedure concerns requests for advance rulings on leveraged lease transactions as described in Rev. Proc. 75-21, 1975-1 C.B. 715, and Rev. Proc. 75-28, 1975-1 C.B. 752. The purpose of this Revenue

[1] Also released as News Release IR-1660, dated August 19, 1976.

Procedure is to set forth the decision of the Service not to issue advance rulings that certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes when the property is "limited use property."

SEC. 2. BACKGROUND.

The Service previously announced in section 5.02 of Rev. Proc. 75-21 that it had not decided whether rulings would be issued in cases involving the leasing of property not expected to be useful to or useable by the lessor at the end of the lease term except for purposes of continued leasing or transfer to a member of the lessee group. Such property is referred to herein as "limited use property."

SEC. 3. DECISION.

Rev. Proc. 75-21 sets forth guidelines relating to advance rulings on leveraged lease transactions. Section 4(1)(C) of those guidelines requires the lessor to represent and demonstrate certain facts relating to the estimated fair market value and estimated remaining useful life of the property at the end of the lease term. This requirement is intended, in part, to assure that the purported lessor has not transferred the use of the property to the purported lessee for substantially its entire useful life. In the case of limited use property, at the end of the lease term there will probably be no potential lessees or buyers other than members of the lessee group. As a result, the lessor of limited use property will probably sell or rent the property to a member of the lessee group, thus enabling the lessee group to enjoy the benefits of the use or ownership of the property for substantially its entire useful life. See Rev. Rul. 55-541, 1955-2 C.B. 19, for an example of a transaction in which property was determined to be leased for substantially its entire useful life and the conclusion that such a transaction transfers equitable ownership. Accordingly, the Service will not issue advance rulings whether certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes when the property is limited use property.

SEC. 4. PROCEDURE

Pursuant to Rev. Proc. 75-28 taxpayers requesting an advance ruling in a leveraged lease transaction must furnish to the Service certain information and representations. If the information required to be furnished by section 4.09 of Rev. Proc. 75-28 fails to establish that the property is not limited use property, the Service will decline to issue an advance ruling on the transaction. Such information must establish to the satisfaction of the Service that the use of the property at the end of the lease term by the lessor or some person, other than a member of the lessee group, who could lease or purchase the property from the lessor, is commercially feasible to the lessor or to both respectively. The Service's determination of commercial feasibility will be based on the standards that would be applied by reasonably prudent businessmen on the basis of present knowledge and generally accepted engineering standards.

SEC. 5. EXAMPLES.

The following examples illustrate the types of property the Service considers to be limited use property, and the types of property the Service does not consider to be limited use property.

(1) *X* builds a masonry smokestack attached to a masonry warehouse building owned by *Y*, and leases the smokestack to *Y* for use as an addition to the heating system of the warehouse. The lease term is 15 years; the smokestack has a useful life of 25 years, and the warehouse has a remaining useful life of 25 years. It would not be commercially feasible to disassemble the smokestack at the end of the lease term and reconstruct it at a new location. The smokestack is considered to be limited use property.

(2) *X* builds a complete chemical production facility on land owned by *Y* and leases the facility to *Y*, a manufacturer of chemicals. The lease term is 24 years, and the facility has a useful life of 30 years. The land is leased to *X* pursuant to a ground lease for a term of 30 years. The technical "know-how" and trade secrets *Y* possesses are necessary elements in the commercial operation of the facility. At the time the lease is entered into no person who is not a member of the lessee group possesses the technical "know-how" and trade secrets necessary for the commercial operation of the facility. The taxpayers submit to the Service the written opinion of a qualified expert stating it is probable that by the expiration of the lease term of the facility third parties who are potential purchasers or lessees of the facility will have independently developed such "know-how" and trade secrets. The facility is considered to be limited use property. In reaching this conclusion, the Service will not take into account such expert opinion because such opinions are too speculative for advance ruling purposes.

(3) The facts are the same as in the examples set forth in subsection (2) except *X* has an option, exercisable at the end of the lease term of the facility, to purchase from *Y* the "know-how" and trade secrets necessary for the commercial operation of the facility, and it would be commercially feasible at the end of such lease term for *X* to exercise the option and operate the facility itself. The facility is not considered to be limited use property.

(4) The facts are the same as in the example set forth in subsection (2) except it would be commercially feasible for the lessor at the end of the lease term to make certain structural modifications of the facility that would make the facility capable of being used by persons not possessing any special technical "know-how" or trade secrets. Furthermore, if such modifications were made, it would be commercially feasible, at the end of the lease term, for a person who is not a member of the lessee group to purchase or lease the facility from *X*. The facility is not considered to be limited use property.

(5) *X* builds an electrical generating plant on land owned by *Y* and leases the plant to *Y*. The lease term is 40 years, and the plant has an estimated useful life of 50 years. The land is leased to *X* pursuant to a ground lease for a term of 50 years. The plant is adjacent to a fuel source that it is estimated will last for at least 50 years. Access to this fuel source is necessary for the commercial operation of the plant, and *Y* has recently obtained the contractual right to acquire all fuel produced from the source for 50 years. *Y* will use the plant to produce and generate electrical power for sale to a city located 500 miles away. The plant is synchronized into a power grid that makes the sale of electrical power to a number of potential markets commercially feasible. It would not be commercially feasible to disassemble the plant and reconstruct it at a new location. The electrical generating plant is considered to be limited use property because access to this fuel source held exclusively by *Y* is necessary for the commercial operation of the plant.

(6) The facts are the same as in the example set forth in subsection (5) except *X* has an option, exercisable at the end of the lease term of the plant, to acquire from *Y* the contractual right to acquire all fuel produced from the fuel source for the 10-year period commencing at the end of such lease term. It would be commercially feasible at the end of such lease term for *X* to

exercise this option. Furthermore, it would be commercially feasible, at the end of such lease term, for a person who is not a member of the lessee group to purchase the contractual right to the fuel from *X* for an amount equal to the option price and purchase or lease the plant from *X*. The plant is not considered to be limited use property.

SEC. 6. EFFECT ON OTHER DOCUMENTS.

Rev. Proc. 75-21 is modified.

SEC. 7. INQUIRIES.

Inquiries in regard to this Revenue Procedure should refer to its number and be addressed to the Commissioner of Internal Revenue, Attention T:C:C, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 46, 401, 403, 405; 1.46-1, 1.401-1, 1.403(a)-1, 1.405-1.)

Rev. Proc. 76-31

SECTION 1. BACKGROUND AND PURPOSE.

.01 The Employee Retirement Income Security Act of 1974 ("ERISA"), Pub. L. 93-406, 88 Stat. 829, 1974-3 C.B. 1, approved September 2, 1974, made substantial changes relating to the qualification requirements applicable to employee plans under sections 401(a), 403(a), and 405(a) of the Internal Revenue Code of 1954.

.02 In recognition of the need to provide an immediate and complete set of interim guidelines to facilitate (1) adoption of new employee plans, and (2) prompt amendment of existing employee plans, in conformance with the requirements of the Code as amended by ERISA, the Internal Revenue Service and the Department of Labor have issued a compendium of rules and regulations (referred to as the "ERISA Guidelines" and attached hereto as Appendix A).

.03 This Revenue Procedure establishes a special procedure (referred to as the "Special Reliance Procedure"), the principal feature of which is a reliance rule which generally assures that, for employee plans which comply with the Special Reliance Procedure, the qualification rules will be treated as fixed for a certain period ("Reliance Period") so that they can be relied upon for drafting employee plans, and amendments thereto, without regard to subsequent changes in the ERISA Guidelines. The Special Reliance Procedure may be followed in conforming employee plans to the requirements of ERISA and section 301(d) of the Tax Reduction Act of 1975.

SEC. 2. DEFINITIONS.

.01 "Employee plan" or "plan" means (1) a pension, annuity, profit-sharing, stock bonus, or bond purchase plan, or (2) an employee stock ownership plan under section 301(d) of the Tax Reduction Act of 1975. Unless otherwise indicated or clearly required by context, the term employee plan or plan includes an individually designed, multiple employer, multi-employer, master or prototype plan.

.02 "ERISA Guidelines" means the compendium of rules and regulations of the Service and the Department of Labor which must be observed to satisfy the qualification provisions of the Code as added or amended by ERISA and the parallel requirements of parts 2 and 3 of subtitle B of Title I of ERISA, or where applicable, the requirements of section 301(d) of the Tax Reduction Act of 1975. The rules and regulations comprising the ERISA Guidelines are listed in Appendix A.

SEC. 3. CONDITIONS FOR SPECIAL RELIANCE.

.01 Except as provided in sections 4, 5, and 7.02, an employer adopting an employee plan or amendments thereto shall be entitled to rely upon the ERISA Guidelines (relating to the requirements for qualification under sections 401(a), 403(a) and 405(a) of the Code) during the Reliance Period as set forth in section 7.01, if

(1) the plan is adopted or amended on or before September 30, 1976,

(2) the plan complies with requirements of the Code which were not changed by the enactment of ERISA,

(3) the plan complies with the requirements set forth in the ERISA Guidelines, and with respect to areas not covered by the Guidelines, the plan employs provisions which are reasonable in light of the circumstances and which give effect to the intent of the statute as indicated in the legislative history, and

(4) the plan provisions necessary to comply with any such ERISA Guideline are made effective as of the first date to which such guideline is applicable.

.02 A plan or amendment is considered to be adopted when it has been reduced to writing and approved by the employer (including in the case of a corporate employer any necessary action of the board of directors and the shareholders) notwithstanding that (a) no amounts have been contributed under the plan, and (b) the effective date of such plan or amendment is after September 30, 1976. See also section 3.04.

.03 With regard to a plan which complies with the requirements of sections 3.01(1) and (4) but does not comply with the requirements of sections 3.01(2) or (3) the plan will be deemed to have met the requirements of sections 3.01(2) and (3) provided that

(1) the plan is submitted to the Service for an advance determination letter on or before the last day of the third month following the date specified in section 3.01(1), and

(2) such plan is amended retroactively, in accordance with the requirements of section 401(b) of the Code and the regulations thereunder, to the extent necessary to comply with sections 3.01(2) and 3.01(3).

.04 In the case of a plan described in section 413(a) or (c) of the Code, a plan amendment will be deemed to be adopted under section 3.02 when there is a legally enforceable agreement to establish or amend such a plan by the employer.

.05 The requirement of section 3.01(1) will not fail to be satisfied with respect to any employer merely because such employer adopts a plan

described in section 413(a) or (c) of the Code, or becomes part of a plan maintained by another employer, after September 30, 1976, if at least one employer adopts such plan on or before such date.

.06 The provisions of this section can be illustrated as follows:

A calendar year taxpayer adopts a new plan on November 30, 1974, with a plan year commencing October 1, 1974. As of November 30, 1974, all actions required by the employer to adopt the plan have been completed. This adoption satisfies the requirement of section 3.01(1) because it was adopted before September 30, 1976. The employer is eligible for the Special Reliance Procedure only if the other requirements of section 3.01 are satisfied. However, if the employer requests a determination letter as to the qualified status of the plan on or before December 31, 1976, and if the employer corrects any defect in the plan (in accordance with section 3.03(2)) retroactively to October 1, 1974, such employer is eligible for the Special Reliance Procedure with respect to such plan.

SEC. 4. MASTER AND PROTOTYPE PLANS.

.01 Except as provided in section 7.02 below, an employer who adopts a master or prototype plan or whose previously adopted master or prototype plan is amended shall be entitled to rely upon the ERISA Guidelines during the Special Reliance Period as set forth in section 7.01, if

(1) the sponsoring organization submits the plan to the National Office of the Service for an opinion letter in compliance with Rev. Proc. 75-51, 1975-2 C.B. 590, or Rev. Proc. 75-52, 1975-2 C.B. 592, on or before September 30, 1976,

(2) the requirements of sections 3.01(2), (3), and (4) are satisfied,

(3) the sponsor obtains a favorable opinion letter, and

(4) the employer adopts the master or prototype plan either as a new plan or as a restatement of an existing plan (whether or not a master or prototype plan), or, in the case of a previously adopted master or prototype plan, adopts any necessary amendments to related plan documents, retroactively effective for all purposes not later than the later of (a) June 30, 1977, or (b) the last day of the month that is six months after the month in which a favorable opinion letter is issued by the Service to the sponsoring organization. The requirement of this paragraph regarding necessary amendments to related plan documents is deemed satisfied in the case of a plan which is part of an existing master or prototype plan where the amendments made by the sponsoring organization bring the plan into compliance without any additional action by the employer.

.02 The requirements of section 4.01(1) shall be deemed to be satisfied unless the opinion letter contains a statement that the Special Reliance Procedure is not applicable to the master or prototype plan.

.03 In the case of an employer that adopts a master or prototype plan otherwise eligible to receive a determination letter, district offices will not honor a request for a determination letter while a request for an opinion letter with respect to the plan is pending before the National Office.

.04 The Service will publish in the Internal Revenue Bulletin,

(1) after September 30, 1976, a list of the sponsoring organizations and their related plans which satisfy the requirements of section 4.01(1), and

(2) lists of sponsoring organizations and their related plans which

(a) receive unfavorable opinion letters, or

(b) withdraw their requests for opinion letters.

In the case of a sponsoring organization which establishes a new master or prototype plan to replace an existing master or prototype plan in lieu of amending such existing master or prototype plan, such new master or prototype plan will be listed as a continuation of such existing master or prototype plan if the sponsoring organization notifies the Internal Revenue Service of such continuation in writing before September 30, 1976. Such written notification shall be sent to Commissioner of Internal Revenue, Washington, D.C. 20224, Attention: E:EP:T.

.05 A participating employer whose master or prototype plan is not included in the list described in section 4.04(1) may obtain the benefits of this Revenue Procedure by satisfying the requirements of section 3 or 5. However, for this purpose the date specified in section 3.01(1) shall be extended to the last day of the month which is six months after the month of publication of such list.

.06 A participating employer whose master or prototype plan is included in one of the lists described in section 4.04(2) may obtain the benefits of this Revenue Procedure by satisfying the requirements of section 3 or 5. However, for this purpose the date specified in section 3.01(1) shall be extended to the last day of the month which is six months after the month of publication of such list.

.07 A participating employer who amends a plan and satisfies the requirements of section 3 or 5 in lieu of adopting or retaining the sponsoring organization's approved plan may obtain the benefits of this Revenue Procedure. However, for this purpose the date described in section 3.01(1) shall be extended to the last day of the month which is six months after the month in which a favorable opinion letter is issued by the Service.

.08 For the purposes of sections 4.05, 4.06, and 4.07, a participating employer means an employer who participates in a master or prototype plan on any date on or after the date the sponsoring organization satisfies section 4.01(1) or, in the case of a sponsoring organization which does not satisfy section 4.01(1), who participates therein on September 30, 1976.

SEC. 5. DISTRICT-APPROVED PATTERN PLANS.

.01 Except as provided in section

7.02 below, an employer who adopts a district-approved pattern plan ("pattern plan") or whose previously adopted pattern plan is amended shall be entitled to rely upon the ERISA Guidelines during the Special Reliance Period as set forth in section 7.01 below, if

(1) on or before September 30, 1976, a law firm submits the pattern plan to the Service for a notification letter in compliance with Rev. Proc. 76-15, 1976-1 C.B. 553.

(2) the requirements of sections 3.01(2), (3), and (4) are satisfied,

(3) the law firm obtains a favorable notification letter, and

(4) the employer adopts the pattern plan (or, in the case of a previously adopted plan, adopts any necessary amendments retroactively effective for all purposes) no later than the later of (a) June 30, 1977, or (b) the last day of the month which is six months after the month in which the law firm receives a favorable notification letter.

.02 The requirements of section 5.01(1) shall be deemed to be satisfied unless the notification letter contains a statement that the Special Reliance Procedure is not applicable to such pattern plan.

.03 An employer who adopts a pattern plan which has been submitted by a law firm, on or before September 30, 1976, with a request for a notification letter in compliance with Rev. Proc. 76-15, may obtain the benefits of this Revenue Procedure by satisfying the requirements of section 3 or 4, if

(1) such law firm receives an unfavorable notification letter,

(2) such law firm withdraws such request, or

(3) such employer amends such plan in lieu of retaining such law firm's approved plan.

However, the date specified in section 3.01(1) shall be extended to the last day of the month which is six months after the month in which such law firm receives an unfavorable notification letter, withdraws such request, or receives a favorable notification letter (whichever is applicable).

SEC. 6. EMPLOYEE STOCK OWNERSHIP PLANS UNDER THE TAX REDUCTION ACT OF 1975.

.01 Except as provided in section 7.02, an employee stock ownership plan ("ESOP") which is intended to meet the requirements of section 301(d) of the Tax Reduction Act shall be entitled to rely upon the ERISA Guidelines relating to such section during the Special Reliance Period, if

(1) the requirement of section 3.01 (1) is satisfied,

(2) the plan complies with the requirements set forth in the ERISA Guidelines applicable to plans intended to meet the requirements of such section 301(d) and, with respect to areas not covered by the Guidelines, the plan employs provisions which are reasonable in light of the circumstances and which give effect to the intent of section 301(d) of such Tax Reduction Act as indicated in the legislative history, and

(3) the plan provisions necessary to comply with the ERISA Guidelines are made effective as of the beginning of the first plan year to which the requirements of section 301(d) are applicable.

.02 With regard to a plan which does not comply with section 6.01(2), the plan will be deemed to have met the requirements of section 6.01(2) provided that

(1) the plan is submitted to the Service for an advance determination letter pursuant to Rev. Proc. 75-48, 1975-2 C.B. 583, on or before the date described in section 3.03(1), and

(2) such plan is amended retroactively, in accordance with section 301(d)(11) of the Tax Reduction Act.

SEC. 7. RELIANCE PERIOD.

.01 General—Except as provided in section 7.02 (relating to unusual circumstances) any employee plan which satisfies the provisions of sections 3, 4, 5, or 6 of this Revenue Procedure shall be deemed to have satisfied the requirements of (1) the provisions of sections 401(a), 403(a) or 405(a) of the Code which were added or amended by ERISA and the parallel provisions of parts 2 and 3 of subtitle B of Title I of ERISA or (2) section 301(d) of the Tax Reduction Act, for the entire period from the beginning of the first plan year to which the requirements are applicable to such plan until December 31, 1977. In general, therefore, an employee plan which has been adopted or amended in compliance with sections 3, 4, 5, or 6 of this Revenue Procedure prior to the effective date of any rule or regulation adopted under section 7.02 will not be required to comply with such rule or regulation during the Reliance Period.

.02 Exception for Unusual Circumstances—In unusual circumstances, the Service or the Department of Labor may issue rules and regulations amending or supplementing the ERISA Guidelines which are made effective prior to the expiration of the Reliance Period applicable to a particular employee plan. This exception for unusual circumstances will be availed of by the Service or the Department only where it appears that a fundamental error or omission in the ERISA Guidelines is likely to affect significantly a number of employee plans. Any rule or regulation remedying an omission or correcting an error will generally be made effective, for plans which shall have complied with the Special Reliance Procedure, no sooner than 30 days after the publication of such rule or regulation. However, the Service and the Department of Labor reserve the right to make such a rule or regulation applicable to such a plan during the Reliance Period where, for example, the benefits of employees could be significantly curtailed by a delay in compliance with such a rule or regulation.

.03 An employee plan which is adopted or amended in compliance with sections 3, 4, 5, or 6 more than 30 days after the effective date of a rule

or regulation adopted under section 7.02 shall be required to comply with such rule or regulation at the time of such adoption or amendment.

.04 Subject to the requirements of section 411(a)(10) and (d)(6) of the Code and sections 203(c)(1) and 204(g) of ERISA, reliance on the ERISA Guidelines during the Reliance Period will not be affected merely because the plan is adopted or amended to conform to any change in the ERISA Guidelines promulgated by the Service or the Department of Labor.

SEC. 8. REQUIRED AMENDMENTS.

.01 A plan which is entitled to the benefit of this Special Reliance Procedure must, no later than January 1, 1978, comply with changes in the ERISA Guidelines affecting (1) the qualification requirements of section 401(a), 403(a), or 405(a) of the Code and the parallel provisions of parts 2 and 3 of subtitle B of Title I of ERISA, or (2) the requirements of section 301(d) of the Tax Reduction Act, whichever is applicable. Any such plan will be treated as satisfying such requirements if

(1) it is amended on or before December 31, 1978, to satisfy the requirements of such changes, and

(2) the amendment is effective no later than January 1, 1978.

.02 If a sponsoring organization submits an amendment described in section 8.01(1) to the National Office of the Service for an opinion letter on or before July 1, 1978, then the date described in section 8.01(1) shall be extended to the last day of the month which is six months after the month in which the opinion letter is issued by the Service, if that date is later than the date specified in section 8.01(1).

.03 If a law firm submits an amendment described in section 8.01(1) to the Service for a notification letter on or before July 1, 1978, then the date described in section 8.01(1) shall be extended to the last day of the month which is six months after the month in which the notification letter is issued by the Service, if that date is later than the date specified in section 8.01(1).

.04 An employer, other than an employer in a master or prototype plan designed to benefit self-employed individuals within the meaning of section 401(c)(1) of the Code, may request a determination letter under 26 CFR section 601.201(o) of the Statement of Procedural Rules or under Rev. Proc. 75-48 with respect to plan amendments which are described in section 8.01(1). Such request may be made without filing any application forms, whether or not it also includes plan amendments other than those described in section 8.01(1). The applicant must include a statement indicating that such request is made pursuant to this subsection. In considering such request the Service will limit its consideration to the following:

(1) changes described in section 8.01 that are not reflected in the plan as amended, and

(2) the effect of such amendment on the qualification of the plan under section 401(a), 403(a), or 405(a).

SEC. 9. EFFECT ON OTHER REQUIREMENTS.

.01 Nothing in this Revenue Procedure alters the requirement that a plan must be in existence and communicated to the covered employees by the close of the employer's taxable year in order to be qualified for such taxable year.

.02 Nothing in this Revenue Procedure alters the requirement, for purposes of section 301(d) of the Tax Reduction Act, that an ESOP and accompanying trust must be in existence on or before the last day for making an election under section 46(a)(1)(B) of the Code, i.e., the due date (including extensions of time) for filing the corporation's income tax return for the year in which the credit is earned or, if later, December 31, 1975.

.03 Nothing in this Revenue Procedure alters the requirement that to be qualified a plan must be qualified in operation as well as form. The reliance described in section 7.01 does not extend to plans that are or become disqualified in operation.

.04 Nothing in this Revenue Procedure alters the fact that, to obtain assurance that a plan satisfies the requirements of section 401(a), 403(a), or 405(a) of the Code with respect to the facts peculiar to a particular employer adopting either (1) an approved master or prototype plan not covering any self-employed individual within the meaning of section 401(c)(1), or (2) a pattern plan referred to in section 5, such employer must obtain a determination letter.

SEC. 10. EFFECT ON OTHER DOCUMENTS.

Rev. Proc. 75-47, 1975-2 C.B. 581; Rev. Proc. 75-48, 1975-2 C.B. 583; Rev. Proc. 75-51, 1975-2 C.B. 590; Rev. Proc. 75-52, 1975-2 C.B. 592; and Rev. Proc. 76-15, 1976-1 C.B. 553, are hereby modified.

SEC. 11. EFFECTIVE DATE.

This Revenue Procedure is effective November 5, 1975.

Appendix A.

ERISA GUIDELINES

Publication Date	Document	Subject	Code Section
1/8/75	TIR 1334	Questions and answers relating to defined contribution plans subject to ERISA	410, 411 et al.

Publication Date	Document	Subject	Code Section
4/21/75	40 F.R. 17576	Notice of Proposed Rule Making: Qualification (and other aspects) of HR-10 plans	401(c), 401(d), 401(e), 46, 50A, 72, 404(e), 901, and 1379
9/8/75	40 F.R. 41654	Department of Labor—Minimum Standards for hours of service, years of service, and breaks in service relating to participation, vesting, and accrual of benefits	401(a)(3)(B), 411(a)(5)(C), and ERISA sections 202, 203, and 204
9/17/75	TIR 1403	Questions and answers relating mainly to defined benefit plans subject to ERISA (addition to TIR 1334)	410, 411, et al.
9/18/75	40 F.R. 43034	Notice of Proposed Rule Making: Definitions of multi-employer plan and administrator	414(f) and (g)
9/29/75	T.D. 7377 1975-2 C.B. 139	Temporary Regulations: Certain retroactive amendments of employee plans	401(b)
10/3/75	T.D. 7379 1975-2 C.B. 131	Temporary Regulations: Qualified Joint and survivor annuities	401(a)(11)
10/3/75	T.D. 7380 1975-2 C.B. 151	Temporary Regulations: Minimum Participation Standards	410
10/8/75	T.D. 7381 1975-2 C.B. 135	Temporary Regulations: Commencement of Benefits	401(a)(14)
10/15/75	T.D. 7382 1975-2 C.B. 137	Temporary Regulations: Requirement that benefits under a qualified plan are not decreased on account of certain Social Security increases	401(a)(15)
10/16/75	T.D. 7383 1975-2 C.B. 141	Temporary Regulations: Nonbank trustees of pension and profit sharing trusts benefiting owner-employees	401(d)(1)
10/16/75	40 F.R. 48517	Notice of Proposed Rule Making: Certain Custodial Accounts	401(f)
10/30/75	TIR 1408	Questions and Answers relating to mergers, consolidations, etc.	401(a)(12) and 414(1)
11/3/75	Rev. Rul. 75-480, 1975-2 C.B. 131	Updating of Rev. Rul. 71-446 to reflect changes mandated by ERISA	401(a)(15)
2/9/76	TIR 1444 Rev. Rul. 76-76 1976-1 C.B. 106		
11/3/75	Rev. Rul. 75-481, 1975-2 C.B. 188	Guidelines for determining whether contributions or benefits under plan satisfy the limitations of section 415 of the Code	401(a)(16)
2/2/76	Announcement 76-13.		
11/3/75	TIR-1411 Rev. Proc. 75-49 1975-2 C.B. 584	Vesting and Discrimination	401(a)(4), 411(d)(1)

Publication Date	Document	Subject	Code Section
2/2/76	TIR 1441 Rev. Proc. 76-11, 1976-1 C.B. 550		
11/4/75	TIR-1413	Questions and Answers relating to Employee Stock Ownership Plans	401, 4975, and section 301 (d) of the Tax Reduction Act of 1975
11/5/75	T.D. 7387 1975-2 C.B. 159	Temporary Regulations on Minimum Vesting Standards	411
11/5/75	T.D. 7388 1975-2 C.B. 180	Controlled groups, business under common control, etc.	414(b) and (c)
4/6/76	IR-1589	Nonforfeiture of employee derived accrued benefit upon death	411(a)(1)
11/7/75	40 F.R. 52008	Department of Labor—additional requirements applicable to definition of multiemployer plan	414(f) and ERISA section 3(37)
*		Department of Labor—suspension of benefits upon reemployment of retirees	411(a)(3)(B) and ERISA section 203(a)(3)(B)
12/3/75 1/2/76	TIR-1422 TIR-1430	Assignment or alienation of plan benefits	401(a)(13)
1/28/76	TIR-1439 Rev. Rul. 76-47, 1976-1 C.B. 109	Appropriate conversion factor	411(c)(2)(B)(ii)

* To be published

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 408.)

Rev. Proc. 76-32 [1]

SECTION 1. PURPOSE

.01 The purpose of this Revenue Procedure is to modify Rev. Proc. 75-6, 1975-1 C.B. 646, with respect to the issuance of determination letters relating to individual retirement accounts established by employers and associations of employees as described in section 408(c) of the Internal Revenue Code of 1954, as amended by the Employee Retirement Income Security Act of 1974.

[1] Also released as IR 1667, dated Sept. 8, 1976.

.02 This Revenue Procedure transfers jurisdiction for approval of individual retirement accounts established by employers and associations of employees from the Key District Directors to the National Office and authorizes the National Office to issue rulings as to whether individual retirement accounts meet the requirements of section 408(c) of the Code.

SEC. 2. BACKGROUND AND GENERAL INFORMATION

The general procedures of the Service relating to the issuance of rulings, determination letters, and opinion letters are set forth in Rev. Proc. 72-3, 1972-1 C.B. 698.

Rev. Proc. 75-6 amplifies Rev. Proc. 72-3 and sets forth interim procedures pertaining to the issuance of rulings, determination letters, and opinion letters on the establishment of individual retirement accounts and individual retirement annuities under sections 408 (a), (b), and (c) of the Code, and the status for exemption of a related trust or custodial account under section 408(e). Under Rev. Proc. 75-6, applications from employers or associations of employees were submitted to district directors for approval.

SEC. 3. PROCEDURES

.01 The National Office will issue rulings as to whether individual retirement accounts established by employers and associations of employees

meet the requirements of section 408 (c) of the Code.

.02 Individual retirement accounts with respect to which favorable rulings are issued pursuant to this Revenue Procedure may have to be amended subsequently to include or revise provisions to meet the requirements of regulations adopted after such rulings have been issued. Favorable rulings will not be withdrawn so long as the trust is amended to meet the requirements of those regulations.

SEC. 4. INSTRUCTIONS TO TAXPAYERS

An employer or association of employees that desires a ruling as to whether the individual retirement account established for the benefit of its employees or members meets the requirements of section 408(c) of the Code should submit Form 5306, Application for Approval of Prototype or Employer Sponsored Individual Retirement Account (Rev. June 1976). Form 5306, which formerly was applicable only to prototype individual retirement accounts, has been revised to accommodate these applications. This procedure should be followed whether the application for approval is submitted for a new account or for an amendment to an existing account. The applications should be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224, Attention: E:EP:T.

SEC. 5. TRANSITIONAL RULES

.01 Key District Directors will continue to issue determination letters with respect to applications received by the Internal Revenue Service prior to the effective date of this Revenue Procedure.

.02 Applications seeking approval of individual retirement accounts received on or after the effective date of this Revenue Procedure will be processed in accordance with the provisions of this Revenue Procedure.

SEC. 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 75-6 is hereby modified.

SEC. 7. EFFECTIVE DATE

This Revenue Procedure is effective October 4, 1976.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 501, 509, 521; 1.501 (a)-1, 1.509(a)-1, 1.521-1.)

Rev. Proc. 76-33

SECTION 1. PURPOSE.

This Revenue Procedure sets forth the general appeal procedures with regard to adverse determination letters issued with respect to applications for recognition of exemption from Federal income tax under section 501 or 521 of the Internal Revenue Code of 1954, and with respect to revocation or modification of exemption rulings and determination letters, other than those subject to Rev. Proc. 72-6, 1972-1 C.B. 710 (relating to pension, annuity, profit-sharing, and stock bonus plans). It also lists the 19 key Internal Revenue district offices that handle exempt organization matters.

SEC. 2. BACKGROUND.

The general instructions for processing applications for recognition of exemption under section 501 or 521 of the Code and for revoking or modifying exemption rulings and determination letters are contained in Rev. Proc. 72-4, 1972-1 C.B. 706.

SEC. 3. FILING AND PROCESSING APPLICATIONS FOR RECOGNITION OF EXEMPTION.

An organization seeking recognition of exempt status under section 501 or section 521 of the Code is required to file an application with the key District Director for the Internal Revenue District in which is located the principal place of business or principal office of the organization. Following are the 19 key district offices that process the applications, the Internal Revenue districts covered by each, and the regional office designations:

Key District(s)	IRS Districts Covered
	Central Region
Cincinnati	Cincinnati, Louisville, Indianapolis.
Cleveland	Cleveland, Parkersburg.
Detroit	Detroit.
	Mid-Atlantic Region
Baltimore	Baltimore (which includes the District of Columbia and Office of International Operations), Pittsburgh, Richmond.
Philadelphia	Philadelphia, Wilmington.
Newark	Newark.
	Midwest Region
Chicago	Chicago.
St. Paul	St. Paul, Fargo, Aberdeen, Milwaukee.
St. Louis	St. Louis, Springfield, Des Moines, Omaha.
	North-Atlantic Region
Boston	Boston, Augusta, Burlington, Providence, Hartford, Portsmouth.
Manhattan	Manhattan.
Brooklyn	Brooklyn, Albany, Buffalo.
	Southeast Region
Atlanta	Atlanta, Greensboro, Columbia, Nashville.
Jacksonville	Jacksonville, Jackson, Birmingham.
	Southwest Region
Austin	Austin, New Orleans, Albuquerque, Denver, Cheyenne.
Dallas	Dallas, Oklahoma City, Little Rock, Wichita.

Key District(s)	IRS Districts Covered
	Western Region
Los Angeles	Los Angeles, Phoenix, Honolulu.
San Francisco	San Francisco, Salt Lake City, Reno.
Seattle	Seattle, Portland, Anchorage, Boise, Helena.

SEC. 4. REFERRAL OF MATTERS TO THE REGIONAL OFFICE.

.01 Upon the issuance of an adverse determination letter or a letter proposing revocation or modification of exempt status, the key District Director will advise the organization of its right to protest the determination by requesting regional office consideration. To do this, the organization must submit to the key District Director within 30 days from the date of the letter, a statement of the facts, law, and arguments in support of its position. The organization must also state whether it wishes a regional office conference.

.02 Any determination letter that is issued on the basis of National Office technical advice may not, thereafter, be appealed to the regional or National Offices of the Internal Revenue Service with regard to those issues that were the subject of technical advice.

.03 Upon receipt of an organization's request for regional office consideration, the key District will, if it maintains its position, forward the request and the case file to the Office of the Assistant Regional Commissioner (Employee Plans and Exempt Organizations).

SEC. 5. CONSIDERATION AT REGIONAL OFFICE.

.01 If the regional office, after considering the organization's protest and any additional information developed, disagrees with the key District Director's determination, the regional office will so advise the taxpayer and the case will be returned to the key District Director for appropriate action.

.02 If the regional office, after considering the organization's protest and any information developed, agrees with the key District Director, it will so notify the organization in writing, explaining the reasons therefor and advising the organization that it may, within 30 days from the date of the notification, request National Office consideration (as described in Sec. 6 below). If the organization does not do so within the prescribed time, the case will be returned to the key District Director for issuance of a final determination letter.

.03 Organizations should make full presentation of the facts, circumstances, and arguments at the initial level of consideration, since submission of additional facts, circumstances, and arguments at any level of appeal may result in suspension of appeal procedures and referral of the case back to the key district for additional consideration.

SEC. 6. REFERENCE OF MATTERS TO THE NATIONAL OFFICE.

.01 If the organization wishes to request National Office consideration, it must submit within 30 days to the Regional Office a request for such consideration. The request must state with supporting argument, the ground(s) upon which the request is based (see Sec. 6.02) and whether a conference is desired in the National Office. Upon receipt of the request, the regional office will forward the request and the case file to the National Office in care of the Assistant Commissioner (Employee Plans and Exempt Organizations) E:EO:T (or Assistant Commissioner (Technical) T:C:C in section 521 cases) and will notify the organization of this action.

.02 Upon receipt of the case file in the National Office, a decision will be made whether to accept the case for consideration and the organization will be advised of this decision. The National Office will not accept a case unless the organization can show that the position of the regional office is contrary to the statute, Treasury decision or regulations, or a ruling, opinion or court decision published in the Internal Revenue Bulletin; that the position of the Regional Office is in conflict with the determination made in a similar case in the same or another region; or that the case presents a substantial issue not covered by published precedent. If the National Office decides that the case will be accepted, and if an adverse decision is indicated. the organization will be afforded the opportunity of a conference if one was requested. After consideration by the National Office, the National Office will notify the organization of its decision, and the case file will be returned through the regional office to the key District office for issuance of a final determination letter in accordance with the National Office decision.

.03 If the National Office decides not to accept the case, the case file will be returned through the Regional Office to the key District Director for issuance of a final determination letter.

SEC. 7. EFFECT ON OTHER DOCUMENTS.

Sec. 3, Filing Applications for Recognition of Exemption, Sec. 4, Processing Applications for Recognition of Exemption, Sec. 10, Protest of Adverse Determination Letters, and Sec. 11.02, .03, .04, .05, and .06, Revocation or Modification of Rulings or Determination Letters Recognizing Exemption, of Rev. Proc. 72-4, are hereby superseded.

SEC. 8. EFFECTIVE DATE.

This Revenue Procedure is effective September 27, 1976, the date of its publication in the Internal Revenue Bulletin.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 509, 4942, 4947; 1.509(a)-1, 53.4942(b)-1, 53.4947-1.)

SECTION 1. PURPOSE AND SCOPE.

.01 The purpose of this Revenue Procedure is to supersede Rev. Proc. 73-7, 1973-1 C.B. 753, by providing updated procedures of the Internal Revenue Service with respect to issuing rulings and determination letters on private foundation status under section 509(a) of the Internal Revenue Code of 1954 and operating foundation status under section 4942 (j)(3), of organizations exempt from Federal income tax under section 501 (c)(3). Another purpose is to set forth the procedures with respect to revocations, modifications, and reconsiderations of rulings and determination letters on private foundation and operating foundation status. See Rev. Proc. 72-4, 1972-1 C.B. 706, for procedures of the Service in processing applications for recognition of exemption from Federal income tax under section 501(c)(3). Requests for rulings or determination letters generally are governed by the procedures outlined in Rev. Proc. 72-3, 1972-1 C.B. 698. The general instructions for issuance of determination letters on the foundation status under section 509(a) (3) of nonexempt charitable trusts described in section 4947(a)(1) are contained in Rev. Proc. 72-50, 1972-2 C.B. 830.

.02 Section 3.02 describes the circumstances under which key District Directors issue determination letters on private foundation and operating foundation status and includes requests by an organization, (1) presumed to be a private foundation, (2) previously classified as other than a private foundation, and (3) to reconsider foundation status classification under certain circumstances. Section 4 provides for National Office review of determination letters on foundation status under sections 509 (a) and 4942(j)(3) of the Code. Sections 5, 6, and 7 establish procedures for key District Directors to issue revocations and modifications of rulings and determination letters on foundation and operating foundation status. Section 8 establishes procedures for reconsideration by key District Directors of rulings and determination letters on private foundation and operating foundation status.

SEC. 2. GENERAL.

For the purpose of this Revenue Procedure the term "determination letter" includes a letter issued by a District Director on the basis of technical advice secured from the National Office. When used in this Revenue Procedure, the term "key District Director" means the District Director of one of the Employee Plans and Exempt Organizations key Districts.

SEC. 3. DETERMINATIONS OF FOUNDATION STATUS.

.01 Key District Directors will issue determination letters on foundation status. All adverse determinations issued by key District Directors (including adverse determinations on the foundation status under section 509(a) of nonexempt charitable trusts described in section 4947(a)(1)) are subject to the protest and conference procedures delineated in Rev. Proc. 76-33 page 43, this Bulletin.

.02 Key District Directors will issue such determinations in response to applications for recognition of exempt status under section 501(c)(3)of the Code, or to notifications on Form 4653, Notification of Foundation Status,* submitted by organizations pursuant to section 508(b). Key District Directors will also issue such determinations in response to requests for determination of foundation status by organizations presumed to be private foundations under section 508(b), requests for new determination of foundation status by organizations previously classified as other than private foundations, and requests to reconsider status where the key District Director has decided to reconsider such requests. The requests described in the preceding sentence shall be made in writing. See section 8 for the circumstances in which key District Directors will reconsider rulings and determination letters on private foundation and operating foundation status. For information relating to the circumstances under which an organization presumed to be a private foundation under section 508(b) may request a determination of its status as other than a private foundation, see Rev. Rul. 73-504, 1973-2 C.B. 190.

.03 All requests for determinations referred to in the preceding paragraph should be made to the key District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization.

.04 Where the issue of exemption under section 501(c)(3) of the Code is referred to the National Office for decision under the procedures of Rev. Proc. 72-4, the foundation status issue will also be the subject of a National Office ruling.

SEC. 4. NATIONAL OFFICE REVIEW OF DETERMINATION LETTERS ON FOUNDATION STATUS UNDER SECTIONS 509(a) AND 4942 (j)(3) OF THE CODE.

.01 Section 9 of Rev. Proc. 72-4 provides that determination letters on exemption issues under section 501 of the Code are subject to National Office review. Determination letters concerning foundation status under sections 509(a) and 4942(j)(3) are also subject to review.

.02 If the National Office takes exception to a determination letter, the established procedures described in section 9 of Rev. Proc. 72-4 will be followed.

SEC. 5. REVOCATION OR MODIFICATION OF RULINGS OR DETERMINATION LETTERS UNDER SECTIONS 509(a) AND 4942(j)(3) OF THE CODE—GENERAL.

.01 A ruling or determination letter respecting private foundation or operating foundation status may be revoked or modified by a ruling or determination letter addressed to the organization, or by a Revenue Ruling or other

* Form 4653 is no longer available for filing. Any determinations will be based on a previously submitted Form 4653.

statement published in the Internal Revenue Bulletin.

.02 If a key District Director concludes, as a result of examining an information return or considering information from any other source, that a ruling or determination letter concerning private foundation status (including foundation status under 509(a)(3) of a noncharitable trust described in section 4947(a)(1)) or operating foundation status should be modified or revoked, he should follow the procedures in section 6 or section 7 depending on whether the revocation or modification is adverse or non-adverse to the affected organization.

.03 Where there is a proposal by the Service to change foundation status classification from one particular paragraph of section 509(a) of the Code to another paragraph of that section, the procedures described in section 6 will be followed to modify the ruling or determination letter.

SEC. 6. ADVERSE REVOCATION OR MODIFICATION OF RULINGS OR DETERMINATION LETTERS UNDER SECTIONS 509(a) AND 4942(j)(3) OF THE CODE.

.01 If a key District Director concludes that a ruling or determination letter concerning private foundation or operating foundation status should be revoked or modified, the organization will be advised in writing of the proposed adverse action, the reasons therefor, and the proposed new determination of foundation status. The key District Director will also advise the organization of its right to protest the proposed adverse action by requesting a Regional Office conference. The organization must submit to the key District Director within 30 days from the date of the proposed action, a statement of the facts, law, and arguments in support of its position.

.02 See sections 4, 5 and 6 of Rev. Proc. 76-33, page 655, this Bulletin for the balance of the appeal and protest procedures.

.03 The provisions of this section relating to protest and conference rights before a revocation or modification notice is issued are not applicable to matters where delay would be prejudicial to the interests of the Internal Revenue Service (such as in cases involving fraud, jeopardy, the imminence of the expiration of the statute of limitations, or where immediate action is necessary to protect the interests of the Government).

.04 Unless the effective date of revocation or modification of foundation status or operating foundation status letters is expressly covered by statute or regulation, such effective date generally is the same as the effective date of revocation or modification of exemption letters delineated in section 11.01 of Rev. Proc. 72-4.

SEC. 7. NON-ADVERSE REVOCATION OR MODIFICATION OF RULINGS OR DETERMINATION LETTERS UNDER SECTIONS 509(a) AND 4942(j)(3) OF THE CODE.

If the key District Director concludes that a ruling or determination letter concerning private foundation or operating foundation status should be revoked or modified and that such revocation or modification will not be adverse to the organization, he will issue a determination letter revoking or modifying foundation status. The determination letter will also serve to notify the organization of its foundation status as redetermined. A non-adverse revocation or modification as to private foundation or operating foundation status will ordinarily be retroactive if the initial ruling or determination letter was incorrect.

SEC. 8. RECONSIDERATION OF RULINGS OR DETERMINATION LETTERS UNDER SECTIONS 509(a) AND 4942(j)(3) OF THE CODE.

.01 In cases where an organization believes that it received an incorrect ruling or determination letter as to its private foundation or operating foundation status, the organization may request a key District Director to reconsider such ruling or determination letter. Except in rare circumstances the key District Director will only consider such requests where the organization had not exercised any protest or conference rights with respect to the issuance of such ruling or determination letter.

.02 If a key District Director in his discretion decides that reconsideration is warranted, the request will be treated as an initial request for a determination of foundation status and the key District Director will issue a determination on foundation status or operating foundation status under the procedures of section 3. If a non-adverse determination is issued it will also inform the organization that the prior ruling or determination letter is revoked or modified. Adverse determinations are subject to the protest and conference procedures set out in Rev. Proc. 76-33, page 655, this Bulletin.

.03 If the key District Director decides that reconsideration is not warranted, he will accordingly notify the organization. The organization does not have a right to protest the key District Director's decision not to reconsider.

SEC. 9. EFFECT ON OTHER DOCUMENTS.

Rev. Proc. 73-7, 1973-1 C.B. 753, and Sections 4.04 and .05 of Rev. Proc. 72-50, 1972-2 C.B. 830 are superseded.

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26 CFR 601.204: Changes in accounting periods and in methods of accounting. (Also Part I, Section 332; 1.332-3).

Rev. Proc. 76-35

Rev. Proc. 63-7, 1963-1 C.B. 485, as clarified by Rev. Proc. 75-54, 1975-2 C.B. 594, sets forth rules for determining the taxable year of a foreign corporation for purposes of section 902(d), sections 951 through 972, and sections 1246 through 1248 of the Internal Revenue Code of 1954. The rules set forth in Rev. Proc. 63-7 are equally applicable in determining the taxable year of a liquidating foreign corporation for purposes of section 332(b)(2).

Rev. Proc. 63-7 is amplified.

26 CFR 601.204: Changes in accounting periods and in methods of accounting. (Also Part I, Section 472; 1.472-1.)

Rev. Proc. 76-36

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to modify the provisions of Rev. Proc. 75-36, 1975-2 C.B. 565, relating to the furnishing of financial data to the Bureau of Census (Census) and the Bureau of Economic Analysis (BEA), which are agencies within and under the jurisdiction of the United States Department of Commerce.

SEC. 2. SCOPE.

The scope of this Revenue Procedure is limited to those taxpayers who provide Census with information concerning inventory, for which the taxpayers employ the last-in, first-out (LIFO) inventory method, as described in section 472 of the Internal Revenue Code of 1954.

SEC. 3. BACKGROUND.

.01 Rev. Proc. 75-36 sets forth the procedure to be used by the Internal Revenue Service in the examination of Federal income tax returns involving the LIFO inventory requirements of section 472(c) of the Code for the taxable year in which the taxpayer elects or reelects to use the LIFO inventory method, or extends an existing LIFO election to cover all or a greater portion of its inventories, and Census or BEA requests that the taxpayer furnish certain financial information to the appropriate agency.

.02 Section 472(e)(2) of the Code and the regulations issued thereunder provide, in part, that once the LIFO method is elected, it must be used in all subsequent taxable years, unless the Secretary of the Treasury or the Secretary's delegate determines that the taxpayer has used some procedure other than the LIFO method for any such subsequent taxable year in order to ascertain the income, profit, or loss of such subsequent taxable year, for the purpose of a report or statement covering such taxable year to shareholders, partners, or other proprietors, or beneficiaries, or for credit puposes.

.03 Census collects data on inventories of manufacturing and wholesale firms in the economic census conducted every five years. Similar data are also collected in monthly and/or annual surveys for manufacturing, wholesale, and retail firms. These data are collected under the authority of title 13, United States Code, 13 U.S.C.A. section 9 (Supp. 1975) (title 13). Section 9 of title 13 states that the information collected may not be used "for any purpose other than the statistical purposes for which it is supplied" and further prohibits "any publication whereby the data furnished by any particular establishment or individual under this title can be identified." This section also does not permit "anyone other than the sworn officers and employees of the Department or bureau or agency thereof to examine the individual reports."

.04 Under the provisions of title 13, data collected in Census surveys are exempt from disclosures under the Freedom of Information Act. Data on individual firms may not be released because (1) they are "specifically exempted by statute," and (2) they are "commercial or financial information obtained from a person and privileged or confidential." (Section 552(b)(3) and (b)(4) of title 5, United States Code, 5 U.S.C.A. section 552 (Supp. 1975).)

.05 Census requires taxpayers to submit financial information in the year of the LIFO election, reelection, or extension, as well as in subsequent taxable years. Certain of the required information is not available on a LIFO basis (for example, inventory on a location basis) and some taxpayers have been reluctant to submit the required information because Rev. Proc. 75-36 is limited to the year of the LIFO election, reelection, or extension.

.06 The information to be furnished to Census will not be furnished by the taxpayer to any other persons nor will it be furnished to other government agencies unless otherwise authorized by the Service.

SEC. 4. APPLICATION.

In the examination of returns, a taxpayer's LIFO election will not be terminated for Federal income tax purposes solely because the taxpayer has furnished financial information required by Census to Census on a non-LIFO basis, for the year of the LIFO election, reelection, or extension, as well as for subsequent taxable years. This Revenue Procedure applies to all financial information collected by Census under the authority of title 13, and exempted from disclosure under the Freedom of Information Act, under the authority of title 5, United States Code, 5 U.S.C.A. section 552 (Supp. 1975).

SEC. 6. EFFECT ON OTHER DOCUMENTS.

To the extent provided herein, Rev. Proc. 75-36 is modified.

SEC. 7. INQUIRIES.

Inquiries in regard to this Revenue Procedure should refer to its number and be addressed to the Commissioner of Internal Revenue, Attention T:C:C, 1111 Constitution Avenue, N.W., Washington, D.C. 20224.

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determinations of correct tax liability. (Also Part I, Section 167; 1.167(a)-11.)

Asset depreciation range system; aircraft and air transportation assets. Asset guideline classes, asset guideline depreciation periods and ranges, and annual asset guideline repair allowance percentages are set forth for aircraft and air transportation assets first placed in service after April 15, 1976; Rev. Proc. 72-10 modified.

Rev. Proc. 76-37[1]

SECTION 1. PURPOSE.

The purpose of this Revenue Pro-

[1] Also released as IR-1690, dated November 4, 1976.

cedure is to prescribe under section 1.167(a)-11 of the Income Tax Regulations revised asset guideline classes for aircraft and air transportation assets and to prescribe asset guideline depreciation periods and ranges and annual asset guideline repair allowance percentages for these classes.

The revised guideline classes, asset guideline depreciation periods and ranges, and annual asset guideline repair allowance percentages are set forth in section 2 of this Revenue Procedure.

SEC. 2. ASSET GUIDELINE CLASSES AND PERIODS, ASSET DEPRECIATION RANGES, AND ANNUAL ASSET GUIDELINE REPAIR ALLOWANCE PERCENTAGES FOR AIRCRAFT AND FOR ASSETS USED IN AIR TRANSPORTATION.

The asset guideline classes, asset guideline depreciation periods and ranges, and annual asset guideline repair allowance percentages are prescribed as set forth below.

References in the "Description of Assets Included" for class 45.0 to Civil Aeronautics Board uniform accounts do not limit the applicability of the description to taxpayers regulated by the Civil Aeronautics Board. Rather, these references are included to provide a set of detailed definitions for all taxpayers who own depreciable assets used in air transportation.

Asset Guideline Class	Description of Assets Included	Asset Depreciation Range (in years)			Annual Asset Guideline Repair Allowance Percentage
		Lower Limit	Asset Guideline Period	Upper Limit	
00.21	Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines)	5	6	7	14.0
45.0	Air Transport: Includes assets (except helicopters) used in commercial and contract carrying of passengers and freight by air. For purposes of section 1.167(a)-11(d)(2)(iv)(*a*) of the regulations, expenditures for "repair, maintenance, rehabilitation, or improvement" shall consist of direct maintenance expenses (irrespective of airworthiness provisions or charges) as defined by Civil Aeronautics Board uniform accounts 5200, maintenance burden (exclusive of expenses pertaining to maintenance buildings and improvements) as defined by Civil Aeronautics Board uniform accounts 5300, and expenditures which are not "excluded additions" as defined by section 1.167(a)-11(d)(2)(vi) of the regulations and which would be charged to property and equipment accounts in the Civil Aeronautics Board uniform system of accounts	9.5	12	14.5	15.0
45.1	Air Transport (restricted) Includes each asset described in the description of class 45.0 which was held by the taxpayer on April 15, 1976, or is acquired by the taxpayer pursuant to a contract which was, on April 15, 1976, and at all times thereafter, binding on the taxpayer. This criterion of classification based on binding contract concept is to be applied in the same manner as under the general rules expressed in section 49(b)(1), (4), (5), and (8) of the Internal Revenue Code of 1954	5	6	7	15.0

SEC. 3. EFFECT ON OTHER DOCUMENTS.

Rev. Proc. 72-10 is modified by the represcription of asset guideline classes 00.21 "Airplanes" and 45.0 "Air Transport" and by the addition of class 45.1 "Air Transport (restricted)" with represcribed and additional guideline depreciation periods and ranges, and annual asset guideline repair allowance percentages as set forth in Section 2 of this Revenue Procedure.

SEC. 4. EFFECTIVE DATE.

The asset guideline classes, asset guideline depreciation periods and ranges, and annual asset guideline repair allowance percentages set forth in this Revenue Procedure are effective for property first placed in service after April 15, 1976. However, see the third sentence of section 1.167(a)-11 (b)(4)(ii) of the regulations, which provides that neither the asset guideline period nor the lower limit of the asset depreciation range applicable to an asset placed in service during the taxable year may be longer than the respective period or limit in effect as of the first day of such taxable year.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 401; 1.401-1.)

Rev. Proc. 76-38[1]

SECTION 1. PURPOSE

This Revenue Procedure authorizes Key District Directors to issue determination letters relating to the qualification of target benefit plans under the Internal Revenue Code of 1954, as amended by the Employee Retirement Income Security Act of 1974 (ERISA). This Revenue Procedure also authorizes the National Office to issue opinion letters as to the acceptability of the form of master and prototype target benefit plans.

SEC. 2. BACKGROUND AND GENERAL INFORMATION

.01 Rev. Proc. 72-6, 1972-1 C.B. 710, sets forth the detailed procedures of the Internal Revenue Service with respect to the issuance of determination letters on the qualification of employees' plans under sections 401 and 405(a) of the Code and the exempt status of related trusts or custodial accounts, if any, under section 501(a). Rev. Proc. 75-47, 1975-2 C.B. 581, sets forth supplemental and revised procedures of the Internal Revenue Service for issuing determination letters on such plans. Section 3.02 of Rev. Proc. 75-47 specifically provides that such determination letters will not be issued on defined contribution plans (including target benefit plans) under which the test for prohibited discrimination under section 401(a) is to be made by reference to benefits rather than contributions.

.02 Rev. Procs. 72-7, 1972-1 C.B. 715, and 72-8, 1972-1 C.B. 716, contain procedures relating to the issuance of opinion letters as to the acceptability of the form of master and prototype plans, including plans which cover self-employed individuals. Rev. Procs. 75-51, 1975-2 C.B. 590, and 75-52, 1975-2 C.B. 592, set forth supplemental and revised procedures pertaining to the issuance of opinion letters by the National Office as to the acceptability of the form of certain master and prototype plans, including plans covering self-employed individuals. Section 3.02(2) of each Rev. Proc. provides that opinion letters will not be issued with respect to plans (including target benefit plans) under which the test for prohibited discrimination under section 401(a)(4) of the Code is to be made by reference to benefits rather than contributions.

.03 Revenue Ruling 76-464, page 115, this Bulletin, provides guidelines with respect to earnings assumptions on contributions to target benefit plans for purposes of determining whether there exists prohibited discrimination under section 401(a)(4) of the Code.

SEC. 3. DETERMINATION AND OPINION LETTERS

.01 The Key District Directors are now authorized to issue determination letters with respect to the qualification of target benefit plans and the status for exemption, from Federal income tax, of related trusts or custodial accounts (if any).

.02 The National Office is now authorized to issue opinion letters as to the acceptability of the form of master and prototype target benefit plans, including plans designed to benefit self-employed individuals, and issue rulings as to the status for exemption, from Federal income tax, of related master trusts or custodial accounts (if any).

.03 The determination and opinion letters authorized by this section are those on plans that have not previously received a determination or opinion letter, and plans that have been amended to meet the requirements of Rev. Rul. 76-464.

SEC. 4. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 75-47 is hereby modified by deleting from the last sentence in section 3.02 the word "including" and substituting therefor the words "except for".

.02 Rev. Proc. 75-51 is hereby modified by deleting the word "including" from section 3.02(2) and substituting therefor the words "except for".

.03 Rev. Proc. 75-52 is hereby modified by deleting the word "including" from section 3.02(2) and substituting therefor the words "except for".

.04 All other provisions of these Revenue Procedures are applicable to requirements for determination and opinion letters on target benefit plans.

SEC. 5. EFFECTIVE DATE

This Revenue Procedure is effective November 5, 1976.

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26 CFR 601.602: Forms and instructions.
(Also Part I, Section 6011; 1.6011-1.)

Rev. Proc. 76-39

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to modify section 3.03 of

[1] Also released as IR-1691 dated November 5, 1976.

Rev. Proc. 75-20, 1975-1 C.B. 688, and section 3.03 of Rev. Proc. 75-27, 1975-1 C.B. 725, by setting forth conditions under which a transmitter, service bureau, paying agent, or disbursing agent may sign the affidavit provided on Form 4804, Annual Summary and Transmittal of Income Tax and Information Statements Reported on Magnetic Tape or Disk Pack, on behalf of payers, and the affidavits provided on Form 1096, Annual Summary and Transmittal of U.S. Information Returns, and Form W-3, Transmittal of Income and Tax Statements, on behalf of filers of paper documents.

SEC. 2. BACKGROUND AND REVISED PROCEDURES FOR FILING TAPE REPORTS AND DISK REPORTS.

Section 3.03 of Rev. Proc. 75-20 and section 3.03 of Rev. Proc. 75-27 provides that only the payer can sign the affidavit provided on Form 4804, Form 1096, and Form W-3. It has been brought to the attention of the Internal Revenue Service that the requirement of obtaining each payer's signature on the affidavit is administratively burdensome to a transmitter, service bureau, paying agent, or disbursing agent who files Forms 4804 on behalf of a group of payers reporting on magnetic tape or disk pack. This same administrative burden is also present with respect to the signing of the affidavit provided on Form 1096 and Form W-3 by the payers reporting on paper documents.

In order to relieve this administrative burden, sections 3.03 of Rev. Proc. 75-20 and of Rev. Proc. 75-27 are modified to read as follows:

.03 Form 4804, Annual Summary and Transmittal of Income, Tax, and Information Statements Reported on Magnetic Tape or Disk Pack, will be required from each payer to cover each payer's portion of the tape or disk file. The required Form 4804 must be filed with the shipment of magnetic tape or disk. If only a portion of the returns are submitted on magnetic tape or disk, include a statement that the remaining returns are being submitted in the form of paper documents. Note on the address side of the magnetic tape or disk shipments, "DELIVER UNOPENED TO THE TAPE LIBRARY."

Form 1096, Annual Summary and Transmittal of U.S. Information Returns, or Form W-3, Transmittal of Income and Tax Statements, as appropriate, must be included in the shipment of paper documents. If only a portion of the returns are submitted on paper documents, include a statement with the Form 1096 or W-3 that the remaining returns are being filed in the form of magnetic tape or disk. Please note that Form 1096 or W-3 instructions normally apply to the filing of information returns on paper; however, filers of magnetic tape and disk must review the Form 1096 instructions and file Schedule A (Form 1096), if appropriate.

The affidavit provided on Form 4804, Form 1096, or Form W-3 must be signed by or in the name of the payer. However, the transmitter, service bureau, paying agent, or disbursing agent may sign on behalf of the payer only if all of the following conditions are met:

(a) the transmitter, service bureau, paying agent, or disbursing agent possesses the authority to sign the affidavit under an agency agreement (either oral, written, or implied) that is valid under state law; and

(b) the transmitter, service bureau, paying agent, or disbursing agent has the responsibility (either oral, written, or implied) conferred upon it by the payer to request the taxpayer identifying numbers of payees who are reported on the tape or disk pack documents or the paper documents; and

(c) the authorized transmitter, service bureau, paying agent, or disbursing agent signs the affidavit and appends the caption:

"For: [name of payer]."

The signing of the affidavit by an authorized transmitter, service bureau, paying agent, or disbursing agent on behalf of the payer will not relieve the payer of the requirements of filing a correct, complete, and timely Form 4804 and attachments, and will no relieve the payer of any penalties aris ing from the failure to comply witl those requirements.

SEC. 3. EFFECT ON OTHER DOCU MENTS

This Revenue Procedure modifie Rev. Proc. 75-20 and Rev. Proc. 75 27.

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26 CFR 601.602: Forms and instructions (Also Part I, Sections 6001, 6011, 6018 6019; 1.6001-1, 1.6011-1, 20.6018-1 25.6019-1.)

Rev. Proc. 76-40

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to restate the requirements of the Internal Revenue Service relating to the preparation of acceptable reproductions and private printing of substitute Federal tax return forms and schedules for filing purposes in lieu of the official forms and schedules. Rev. Proc. 75-45, 1975-2 C.B. 579, is superseded.

SEC. 2. GENERAL INSTRUCTIONS.

.01 When filing reproduced or privately printed Federal tax returns and related schedules, use the preaddressed label furnished by the Service on the copy that is to be filed with the Internal Revenue Service.

.02 State tax information must *not* appear on the Federal tax return which is filed with the Internal Revenue Service Center, except amounts claimed on line *11*, Schedule A (Form 1040) as a state tax deduction.

.03 File reproduced or privately printed Federal tax returns and related schedules, using the envelope enclosed with the taxpayer's package. *Do not* use the Service provided tax package envelope for other correspondence with the IRS.

.04 File only *original* filled-in Forms 1040 and related schedules.

.05 Attach all Employees Wage and Tax Statements to the front of Form 1040.

.06 Attach all schedules in alphabetical order and forms other than

W-2 or W-2P in numbered order to the back of Form 1040.

.07 Attach all payments to the front of Form 1040.

.08 Space must be provided on page 1 of Form 1040 for the Preparer's signature (other than taxpayer) and the Preparer's Employer Identification or Social Security Number and address.

SEC. 3. SPECIFICATIONS.

.01 Subject to the conditions enumerated in Section 5, the Service will accept, for filing purposes, exact facsimile reproductions of any of the following tax return forms and schedules:

U.S. Estate Tax Return, Form 706.

U.S. Quarterly Gift Tax Return, Form 709.

U.S. Individual Income Tax Return, Form 1040.

Itemized Deductions AND Dividends and Interest Income, Schedules A & B (Form 1040).

Profit or (Loss) From Business or Profession, Schedule C (Form 1040).

Capital Gains and Losses, Schedule D (Form 1040).

Supplemental Income Schedule, Schedule E (Form 1040).

Farm Income and Expenses, Schedule F (Form 1040).

Income Averaging, Schedule G (Form 1040).

Credit for the Elderly, Schedules R & RP (Form 1040).

Computation of Social Security Self-Employment Tax, Schedule SE (Form 1040).

U.S. Individual Income Tax Return, Short Form 1040A.

U.S. Departing Alien Income Tax Return, Form 1040 C.

U.S. Fiduciary Income Tax Return, Form 1041.

Capital Gains and Losses, Schedule D (Form 1041).

Beneficiary's Share of Income, Deductions, Credits, etc., Schedule K-1 (Form 1041).

Allocation of Accumulation, Distribution, Schedule J (Form 1041).

U.S. Partnership Return of Income (Form 1065).

Partner's Share Income, Credits, Deductions, etc., Schedule K-1 (Form 1065).

U.S. Corporation Income Tax Return, Form 1120.

Capital Gains and Losses, Schedule D (Form 1120).

U.S. Small Business Corporation Income Tax Return, Form 1120S.

Capital Gains and Losses, Schedule D (Form 1120S).

.02 Specifications.—Basic specifications such as margin, pagination, etc., will be printed in the margins of the reproduction proofs and must be removed before printing. The official reproduction proof margins across the top, bottom, and sides must be maintained on all reproductions and privately printed Federal tax returns and related schedules.

SEC. 4. PHYSICAL ASPECTS.

The conditions with respect to size, number of printed pages, quality of paper, and color of both paper and ink are as follows:

Form No. (1)	Official IRS trim size [1] (inches) (2)	Tolerance permitted in size [2] (3)	Number of printed pages (4)	Color of	
				Paper (5)	Ink (6)
706	8⅜ × 11	———	16	White	Black
709	8½ × 11	———	2	Buff	"
*1040	8 × 11	8½ × 11	2	White	"
*Schedules A & B, 1040	8 × 11	8½ × 11	2	"	"
*Schedule C, 1040	8 × 11	8½ × 11	2	"	"
*Schedule D, 1040	8 × 11	8½ × 11	2	"	"
*Schedule E, 1040	8 × 11	8½ × 11	1	"	"
*Schedule F, 1940	8 × 11	8½ × 11	2	"	"
*Schedule G, 1040	8 × 11	8½ × 11	4	"	"
*Schedules R & RP	8 × 11	8½ × 11	2	"	"
*Schedule SE, 1040	8 × 11	8½ × 11	1	"	"
*1040A	**8 × 5½	———	2	"	"
*1040C	8 × 11	8½ × 11	4	"	"
1041	8 × 11	8½ × 11	2	"	"
Schedule D, 1041	8 × 11	8½ × 11	2	"	"
Schedule K-1, 1041 [3]	8 × 11	8½ × 11	5	"	"
Schedule J, 1041	8 × 11	8½ × 11	2	"	"
1065	8½ × 11	———	4	"	"
Schedule K-1, 1065 [3]	8½ × 11	———	5	"	"
1120	8½ × 11	———	4	"	"

Form No. (1)	Official IRS trim size [1] (inches) (2)	Tolerance permitted in size [2] (3)	Number of printed pages (4)	Color of Paper (5)	Color of Ink (6)
Schedule D, 1120	8½ × 11	———	2	"	"
1120S	8½ × 11	———	4	"	"
Schedule D, 1120S	8½ × 11	———	1	"	"

[1] Sizes shown are for single forms furnished by Internal Revenue Service offices; detached size of forms supplied in the Individual Income Tax packages are 8 x 11 inches.

[2] Forms cannot exceed sizes shown, nor be less than size of official forms.

[3] This is a 3-part snapout with a ½- to ¾-inch left-hand stub.

* If approval is necessary, the cut-off date is December 20 of the current year.

** When reproduced or privately printed, Form 1040A must be back-to-back, or page 2 face-to-back of page 1 so as to have a form that is read left to right for Service Center processing without flipping top-to-bottom (head-to-head).

SEC. 5. CONDITIONS.

.01 Reproductions and privately printed substitutes must meet the following conditions:

(a) Must be exact facsimiles of the official forms produced by photo-offset, photo-engraving, photocopying or other similar reproduction process.

(b) Must be on chemical wood writing paper equal to or better than the quality used for the official forms. The thickness of the stock cannot be less than 0.0030 inch.

(c) Must substantially duplicate the colors of the paper and ink of the official form in order to be accepted, except those listed in Section 4. In addition Form 1040 reproductions may be in black ink.

.02 Reproductions must have a high standard of legibility, both as to original form and as to fill-in matter. *The Service reserves the right to reject any reproductions with poor legibility.*

.03 Reproductions and privately printed substitutes may be the same size as that of the official form; or the standard commercial size 8½ x 11 (as noted in columns 2 and 3 of the table in Section 4), except Form 1040A which must not be larger than 8½ x 5½. The image size of printed material should be as close as possible to that of the official form.

.04 Reproductions of official forms and substitute forms which do not meet the requirements of this Revenue Procedure may not be filed in lieu of the official forms and schedules. Supporting statements must provide detail and explain entries made on the official form or schedule, and must furnish all required information in the same sequence as called for on the official forms or schedules and be attached to the form or schedule in the same order as the entries appear on the official forms or schedule. Supporting statements must conform to the size of the form or schedule to which they apply. The totals on all supporting statements must also be entered on the appropriate official form or schedule.

.05 While it is preferred that both sides of the paper be used in making reproductions, resulting in the same page arrangement as that of the official form or schedule, the Service will not object if only one side of the paper is used or if the reproduction has a different fold than that provided on the official form.

SEC. 6. ADDITIONAL INSTRUCTIONS.

.01 The Service ordinarily does not undertake to approve or disapprove the *specific equipment or process* used in reproducing official forms, but requires only that the reproduced forms and schedules satisfy the conditions stated in Sec. 5.01(a), (b) and (c).

.02 Reproductions of forms may be made after insertion of the tax computations and other required information. However, *all signatures on forms to be filed with the Internal Revenue Service must be original signatures, affixed subsequent to the reproduction process.*

.03 Reproduction of forms and schedules meeting the above conditions may be used without prior approval of the Service. However, if specific approval of a reproduction of any such form or schedule is desired, or if the use of a reproduction of any form or schedule not listed herein or otherwise specifically authorized is desired, a sample of the proposed reproduction should be forwarded, by letter, to the Commissioner of Internal Revenue, Attention: ACTS:T:C, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, for consideration. The cut-off date for submitting a request for approval of a reproduction is January 10, 1977.

.04 Once an approval is granted for the use of privately printed or reproduced forms and related schedules, fifty (50) copies of each approved form, and/or related schedule, must be assembled in sets and submitted to ACTS:T:C, so that our field offices will be properly notified.

SEC. 7. REPRODUCTION PROOFS.

Order blanks for reproduction proofs will be mailed to requesters of record and, on request, to prospective users. Printers and others wishing to obtain reproduction proofs may send their requests to the Commissioner, Internal Revenue Service, Washington, D.C. 20224, Attention: A:FM:P.

A charge of $1.00 per page will be made for each reproduction proof regardless of page size. After an order

has been filled, invoices will be mailed to the consignee.

Reproduction proofs are available for the following forms:

Form
1040.
Schedules A & B (1040).
Schedule C (1040).
Schedule D (1040).
Schedule E (1040).
Schedule F (1040).
Schedule G (1040).
Schedules R & RP (1040).
Schedule SE (1040).
1040A.
1041.
Schedule D (1041).
Schedule K-1 (1041).
Schedule J (1041).
1065.
Schedule K-1 (1065).
1120.
Schedule D (1120).
1120S.
Schedule D (1120S).

SEC. 8. EFFECT ON OTHER DOCUMENTS.

This Revenue Procedure supersedes Rev. Proc. 75-45.

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26 CFR 601.602: Forms and instructions. (Also Part I, Sections 6001, 6011; 1.6001-1, 1.6011-1.)

Rev. Proc. 76-41

SECTION 1. PURPOSE.

This Revenue Procedure restates the requirements of the Internal Revenue Service regarding the acceptance of computer-prepared Form 1040 and substitutes for the related schedules. Rev. Proc. 75-44, 1975-2 C.B. 578, is superseded.

SEC. 2. SPECIFICATIONS.

For filing purposes the Service will accept computer-prepared individual income tax returns, Form 1040, and substitutes for the related schedules, provided the forms meet the guidelines prescribed in Sections 3, 4 and 5 below.

SEC. 3. GENERAL INSTRUCTIONS.

.01 A one-half inch margin must be maintained across the top, bottom and sides (exclusive of any pin-feed holes) of all computer-prepared substitute Forms 1040 and related schedules. See exception, Section 5.01.

.02 Use the preaddressed Service supplied label on all computer-prepared substitutes that will be filed with the Internal Revenue Service Centers.

.03 File computer-prepared substitute Forms 1040 and related schedules using the envelope enclosed with the taxpayers' return; *do not* use the Service provided tax package envelope for other correspondence with the IRS.

.04 Identify all computer-prepared substitutes clearly; print the Schedule designation one-half inch from the top margin and one and one-half inches from left margin; print the title centered on the first line of print; and print the taxable year on the same line one-half to one inch from right margin.

.05 State tax information must *not* appear on the Federal tax return which is filed with the Internal Revenue Service Center, except amounts claimed on line *11*, Schedule A (Form 1040) as a State tax deduction.

.06 File only *original* filled-in Forms 1040 and related schedules.

.07 Attach all Employee Wage and Tax Statements to the front of Form 1040.

.08 Attach all schedules in alphabetical order and forms other than W-2 or W-2P in numbered order to the back of Form 1040.

.09 Attach all payments to the front of Form 1040.

.10 Space must be provided on page 1 of Form 1040 for the Preparer's signature (other than taxpayer) and the Preparer's Employer Identification or Social Security Number and address.

EXAMPLE

Interest Expense	
18 Home Mortgage	X----------X
19 Other (See Statement XX)	X----------X
20 Total Interest Expense	X----------X*

SEC. 4. CONDITIONS.

.01 Form 1040.—The weight, size, margins, etc., of the computer-prepared form must meet the requirements specified in Rev. Proc. 76-40, page 662, and the format, except for minor deviations, must follow the format of the official return. To make the form suitable for computer preparation, minor format modifications such as eliminating the vertical lines from the area reserved for social security number, changing the dimensions of the check boxes for filing status, etc., are permitted.

.02 Schedules A & B, C, D, E, F, G, R & RP, and SE.—Computer-prepared substitutes for these forms may be submitted on good quality, standard lined stock machine stationery provided:

(a) The format of each substitute schedule follows the format of the official schedule so far as item caption, line references, sequence, etc., are concerned. With the exception noted below, all line numbers and items must be printed even though they may not have an amount entered.

EXCEPTION.—In the case of substitutes for Schedule A and/or E, detailed information for any deduction or income category may be omitted from the printout if the category total to be reported is zero. However, the substitute schedule must show the total (zero when applicable) for each category. With regard to Schedule A, lines *34-39* need not be shown on the printout; but, the total of itemized deductions must be shown on line *40*.

(b) *Lined stock paper must be used;* the reference code for the items on a schedule may be printed to the left of the caption. (See example below.)

(c) A decimal point is used for each money amount regardless of whether the amount is reported in dollars and cents or in whole dollars.

SEC. 5. ADDITIONAL INSTRUCTIONS.

.01 Form 1040.—Internal control numbers and identifying symbols of the computer preparer may be shown on the facsimile if the use of such numbers or symbols is acceptable to the taxpayer and/or the representative. If shown, such information must not be printed in the top one-half inch clear area, from the center to the right edge, of Forms 1040 and/or Schedules.

.02 Schedules A & B, C, D, E, F, G, R & RP, and SE.—Descriptions for captions, lines, etc., required by the official schedules may be limited to one print line on the substitute by using abbreviations, contractions, and by omitting articles, prepositions, etc. However, *sufficient key words must be retained to permit ready identification of the caption, line or item.*

(a) Explanatory details for entries shown on a substitute schedule may be included on the substitute, or submitted in the form of a supporting statement at the option of the preparer. If a supporting statement is submitted, it must be referenced to the schedule entry which it supports. The entry on the substitute schedule, in turn, must be cross-referenced to the supporting statement. *However, all total lines of all substitutes must have a total printed, carried forward from any supporting statements.* Substitutes for Schedule A must have a money entry for each numbered item on the official form. See exception, Section 4.02(a) above.

(b) Text prescribed for the official form, which is solely instructional in nature, e.g., "Attach this schedule to Form 1040," "See instructions," etc., may be omitted from the substitute schedule.

(c) Information for more than one schedule may not be shown on the same printout page. Any schedule may be continued on two or more pages if necessary. When a schedule is continued onto two or more pages, clearly identify at the bottom of each page, including page 1, that it is continued, e.g. "page 1, Schedule C continued".

SEC. 6. OTHER INFORMATION.

.01 Preparers who desire to file computer prepared substitute Forms 1040 and related schedules must develop such substitutes using these guidelines and must obtain prior approval of the Service before filing substitutes. Proposed substitutes should be forwarded by letter to the Commissioner of Internal Revenue, Attention: ACTS:T:C, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, no later than January 10, 1977. An approval letter from the Internal Revenue Service must be received before the computer prepared substitutes may be used.

.02 Once an approval is granted for the use of computer-prepared substitute Form 1040 and related schedules, fifty (50) copies of each approved form, and/or related schedule, must be assembled in sets and submitted to ACTS:T:C, so that our field offices will be properly notified.

SEC. 7. EFFECT ON OTHER DOCUMENTS.

This Revenue Procedure supersedes Rev. Proc. 75-44.

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 446, 832; 1.446-1, 1.832-4.)

Rev. Proc. 76-42

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is set forth certain conditions that must be met by insurance companies wishing to change their method of accounting for salvage under section 832(b)(5) of the Internal Revenue Code of 1954 and section 1.832-4(c) of the Income Tax Regulations to a method consistent with that permitted in *Continental Insurance Co. v. United States,* 474 F.2d 661 (Ct. Cl. 1973), as a result of the announcement of the Internal Revenue Service to follow such decision in Rev. Rul. 76-487, page 210, this Bulletin.

SEC. 2. BACKGROUND.

The United States Court of Claims, in the *Continental* case, held that if any state in which the taxpayer transacts business has an express statute, rule, or regulation that prohibits the recognition of estimates of future salvage recoveries, then, for Federal income tax purposes, such estimates are not to be taken into account in computing "losses incurred" under section 832(b)(5) of the Code and the regulations thereunder until reduced to cash or its equivalent.

Rev. Rul. 76-487 holds that a consistent method of reducing losses paid by an estimate of future salvage recoveries in computing "losses incurred" is a method of accounting. Thus, any change from such method to a method of taking salvage into account only when reduced to cash or its equivalent requires the consent of the Commissioner of Internal Revenue under section 446(e) of the Code and section 1.446-1(e) of the regulations.

Under section 832(b)(5) of the Code, losses paid during the taxable year are adjusted for salvage and reinsurance recoverable in arriving at losses incurred during the taxable year.

Section 1.832-4(c) of the regulations provides that the adjustment to losses paid for salvage and reinsurance recoverable includes all salvage in the course of liquidation and all reinsurance in process of collection not otherwise taken into account. Salvage in the course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any state, or Territory, or the District of Columbia in which the company transacts business.

SEC. 3. APPLICATION.

The following two conditions must be met by an insurance company

wishing to change its method of accounting for salvage to a method of accounting taking salvage into account only when reduced to cash or its equivalent.

(a) The insurance company must have assumed bona fide insurance risks by the end of the taxable year within a state, Territory, or the District of Columbia, to be considered as having transacted business during such year in such state, Territory, or the Disrict of Columbia; and

(b) One of the states, Territories, or the District of Columbia in which the insurance company transacts business has an express statutory provision (or rules and regulations of an insurance department) that provides that estimates of future salvage recoveries will not be taken into account until reduced to cash or its equivalent.

SEC. 4. PROCEDURE.

Taxpayers desiring to change to the method of accounting prescribed in section 3 of this Revenue Procedure may request permission to do so by filing Form 3115, Application for Change in Accounting Method, with the Commissioner of Internal Revenue, Washington, D.C. 20224, in accordance with section 1.446-1(e)(3) of the regulations and Rev. Proc. 70-27, 1970-2 C.B. 509, as clarified by Rev. Proc. 75-18, 1975-1 C.B. 687.

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

Rev. Proc. 76-43

SECTION 1. PURPOSE.

.01 The purpose of this Revenue Procedure is to update Rev. Proc. 75-33, 1975-2 C.B. 559, which sets forth the conditions under which microfilm (including microfiche) reproduction of general books of account, such as cash books, journals, voucher registers, ledgers, etc., and supporting records of detail will be considered books and records within the meaning of section 6001 of the Internal Revenue Code of 1954.

.02 The following changes have been made to Rev. Proc. 75-33. Previous section 3.03 which permitted a data processing activity to pass along approval of its micrographic system to its taxpayer-users has been eliminated. Previous sections 3.04-6(e) and (f) relating to full size reproduction of documents and image reproduction have been eliminated. A general requirement for legibility and readability has been added in new section 4.01-1. New sections 4.01-2 and 4.01-7 contain revised requirements for archival quality replacing previous sections 3.04-1 and 3.04-2(d). A formula for determining minimum resolution for paper document filming in new section 4.01-5 replaces the requirement in previous section 3.04-2(c). A requirement that taxpayers establish a system of inspection and quality control has been added in new section 4.01-8. New section 4.01-9, replacing previous section 3.04-5, requires that taxpayers will make available upon request by the Service a reader-printer at the examination site.

SEC. 2. BACKGROUND.

Rev. Rul. 75-265, 1975-2 C.B. 460, holds that the microfilm (including microfiche) reproduction of general books of account will be considered books and records within the meaning of section 6001 of the Code when such books and records are in accordance with Rev. Proc. 75-33.

SEC. 3. PROCEDURE.

.01 Taxpayers having a micrographic system that includes the ability to produce records on microfilm directly on-line from the computer or off-line from magnetic tape and taxpayers having records photographed onto microfilm from original documents, "hard copy" printouts, etc., wishing to retain books and records on microfilm must meet the standards set forth in section 4 of this Procedure.

.02 Taxpayers wishing to microfilm general books of account (ledgers, journals, voucher registers, etc.) must submit in writing to their District Director a description of their micrographic system. The description of the micrographic system should include specific information as to how the system conforms with the requirements set forth in this Revenue Procedure.

.03 Permission to retain general books of account on microfilm will be granted only after the Service reviews the taxpayer's micrographic system.

.04 Microfilm may be used for supporting records of details, such as payroll records, cancelled checks, invoices, vouchers, etc., without permission, provided the system meets the requirements set forth in section 4 of this Procedure.

SEC. 4. STANDARDS.

.01 The following standards shall apply to microfilm (including microfiche) submitted to the Service:

1. Microfilm when displayed on a microfilm reader (viewer) or reproduced on paper must exhibit a high degree of legibility and readability. For this purpose, legibility is defined as the quality of a letter or numeral which enables the observer to positively and quickly identify it to the exclusion of all other letters or numerals. Readability is defined as the quality of a group of letters or numerals of being recognizable as words or whole numbers.

2. Microfilm stock to be used for preservation of documents (as set forth in this Revenue Procedure) shall be safety-base permanent record film, as specified in American National Standard Institute (ANSI) PH Series: PH 1.25 "Specifications for safety Photographic Film."

(a) The required master record on microfilm shall be permanent record film as specified in ANSI PH 1.28 "Specifications for photographic film for archival records, Silver Gelatin-type, on Cellulose Ester Base" or PH 1.41 "Specifications for photographic film for archival records, Silver Gelatin-type, on Polyester Base."

(b) In addition to the master rec-

ord the taxpayer may provide a working copy of the microfilm. The working copy may be silver, diazo or vesicular type on a safety-base of cellulose ester or polyester material.

3. On negative microfilm of paper documents, the background density shall be between 0.9 and 1.31. On negative microfilm produced by Computer Output Microfilm (COM), the background density shall be a minimum of 1.1. These requirements apply to both master microfilm and duplicates (copies).

4. On positive microfilm, both from paper documents and COM produced, the background density shall be between 0.04 and 0.40.

5. For paper document filming, the required resolution is to be based on the National Bureau of Standard's Microcopy Resolution Test Chart (Standard Reference Material 1010) using the equation:

$$R = \frac{qr}{e}$$

where R is the resolving power in linse per millimeter; e is the height in millimeters of the lower case "e" in the type to be copied; r is the reduction ratio and q is the "quality index." A minimum quality index (q) of 5 is required.

6. A detailed index of all microfilmed data shall be maintained and arranged in such a manner as to permit the immediate loctaion of any particular record.

7. Taxpayers will provide for appropriate processing, preservation and maintenance of microfilmed records, making them readily available for as long as the contents thereof may become material in the administration of any Internal Revenue law. Archival quality (as defined in ANSI PH 1.28, PH 1.41 and PH.4.8) is required for records requiring long term retention (greater than 10 years). Commercial permanence will be considered adequate for other records. Microfilmed records stored and maintained in accordance with ANSI PH 5.4 will be considered adequate.

8. Taxpayers shall establish a system of inspection and quality control sufficient to ensure that standards 1-7 above are consistently maintained.

9. Taxpayer will make available upon request by the Service a reader-printer at the examination site for the ready reading, location and reproduction of any record or records being maintained on microfilm.

10. The following standards shall apply to the reader-printers made available to the Service:

(a) The equipment shall be in a clean condition and in good working order.

(b) Maintenance of this equipment shall have been in accordance with the manufacturer's specifications.

(c) The equipment shall provide safety features in accordance with UL standards (UL approval not required) and have adequate heat and temperature controls to prevent the damaging of the microfilm being viewed.

(d) The equipment shall have the capability of displaying and printing an entire frame.

(e) This display device shall provide for right reading with the top of the material appearing at the top of the screen.

SEC. 5. EFFECT ON OTHER DOCUMENTS.

Microfilm books of account will add another class of records to those described in Rev. Proc. 64-12, 1964-1 (Part 1) C.B. 672. Retention of machine-sensible records under Rev. Rul. 71-20, 1971-1 C.B. 392, is still required (microfilm is not to be considered machine-sensible media). Rev. Proc. 64-12 is amplified. Rev. Proc. 75-33 is superseded.

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26 CFR 601.202: Closing agreements.
(Also Part I, Sections 367, 1248, 7121; 1.367-1, 1.1248-1, 301.7121-1.)

Rev. Proc. 76-44

Rev. Proc. 75-29, 1975-1 C.B. 754, describes two types of closing agreement that the Internal Revenue Service will generally enter into in certain transactions as a condition to issuing favorable rulings pursuant to section 367 of the Internal Revenue Code of 1954.

Rev. Proc. 76-4, 1976-1 C.B. 543, modified Rev. Proc. 75-29 to provide that the closing agreement described in section 2 of Rev. Proc. 75-29 would remain available to taxpayers whose ruling requests are received by the National Office on or before December 31, 1976.

Rev. Proc. 76-4 is modified by extending the December 31, 1976 cutoff date for the closing agreement described in section 2 of Rev. Proc. 75-29 to include all ruling requests involving exchanges beginning before January 1, 1978.

Rev. Proc. 76-4 is modified.

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26 CFR 601.403: Miscellaneous excise taxes collected by return.
(Also Part I, Section 6011; 49.6011(a)-1.)

Rev. Proc. 76-45

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to provide a method to be used by telephone companies, that are regulated public utilities and that keep their accounts in accordance with the Uniform System of Accounts prescribed by the Federal Communications Commission, for reporting, on Form 720, Quarterly Federal Excise Tax Return, the Federal excise taxes on amounts paid by customers for communications services.

SEC. 2. BACKGROUND.

.01 Rev. Rul. 60-7, 1960-1 C.B. 614, provided a method to be used by certain telephone companies for reporting the collected Federal communications excise taxes on Form 720, which required the various categories of communications taxes be entered separately on the form. Since Form 720 has been revised to require only one entry for the three categories of communications taxes now in effect, Rev. Rul. 60-7 has been superseded by Rev. Rul. 76-560, page 392, this Bulletin, which refers to this Revenue Procedure as setting forth the current

method of reporting such taxes on Form 720 under present law and regulations.

.02 Section 4251 of the Code imposes a tax on amounts paid for local telephone service, toll telephone service, and teletypewriter exchange service. The taxes imposed by that section are to be paid by the person paying for the services.

.03 Section 4291 of the Code provides that every person receiving any payment for services, on which a communications tax is imposed upon the payor, shall collect the amount of the tax from the person making such payment. Section 7501 provides that whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of the tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

.04 Section 6011(a) of the Code provides that when required by regulations prescribed by the Secretary of the Treasury or the Secretary's delegate any person made liable for any tax imposed by the Code, or for the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary or the delegate. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

.05 Section 6415(a) of the Code provides for the allowance of a credit or refund of any overpayment of tax imposed by section 4251 to the person who collected the tax and paid it to the Secretary or the delegate if such person establishes, under such regulations as the Secretary or the delegate may prescribe, that the amount of such tax has been repaid to the person from whom collected, or obtains the consent of such person to the allowance of such credit or refund.

.06 Section 49.6011(a)-1(a) of the Facilities and Services Excise Tax Regulations provides that liability for tax imposed under chapter 33 of the Code shall be reported on Form 720 and that each return required under the regulations in this part, together with any prescribed copies, records, or supporting data, shall be filled in and disposed of in accordance with the forms, instructions, and regulations applicable thereto. In accordance with section 49.6302(c)-1, persons required to file quarterly excise tax returns on Form 720 are required, under certain conditions, to make monthly or semimonthly deposits of excise taxes collected in a Federal Reserve Bank or other authorized depositary. Further, where such persons compute the amount of tax required to be paid over on the basis of amounts billed during a monthly or semimonthly period, section 49.6302(c)-1(a)(1)(iii) provides that the tax shall be considered as collected during the succeeding monthly period or during the second succeeding semimonthly period.

SEC. 3. SCOPE AND OBJECTIVE.

This Revenue Procedure applies to telephone companies that are regulated public utilities and that keep their accounts in accordance with the Uniform System of Accounts prescribed by the Federal Communications Commission. Such companies maintain a subaccount into which all items of Federal excise taxes on communications services billed to or otherwise collected from customers are recorded. Items of adjustment applicable to prior months, within the applicable period of limitations on the allowance of credits or refunds, are also recorded in this subaccount. The net amount of tax liability reflected in this subaccount for a given month represents the "tax as adjusted" for purposes of Form 720.

SEC. 4. APPLICATION.

.01 Under the statute and regulations, telephone companies are required to collect the tax on local telephone service, toll telephone service, and teletypewriter exchange service and pay it over to the Government. Each company is required to file a quarterly return on Form 720. The tax on communications services for the quarter is to be entered in Part 1 of the Form as a single figure on the line provided for the communications tax. Where the company has no other Federal excise taxes to report that figure is to be entered as the "total tax" in Part 1 and in Item 1 of Part 2. The "adjustments" (overpayments, etc.) are to be entered in Item 2 of Part 2 and the "tax as adjusted" is to be entered in Item 3 of that Part. However, where telephone companies keep their accounts in accordance with the Uniform System of Accounts prescribed by, and under the control of, the Federal Communications Commission, such companies may report collected excise taxes on amounts paid for communications services, as follows:

(1) The amount to be used for payment, or for purposes of making monthly deposits, or (if required) semimonthly deposits, of communications taxes is the net amount in the subaccount at the end of each month or at the end of the semimonthly period. The net amount in the subaccount at the end of each month or semimonthly period does not include amounts computed on the basis of billings to customers during that monthly or semimonthly period. The net amount reflects amounts billed to, but not collected from, customers in the previous monthly period or in the second preceding semimonthly period.

(2) The amount to be entered on Form 720 in Part 1, as the tax for "toll telephone service", "teletypewriter exchange service", and "local telephone service" and as the "total tax," and as Item 3 of Part 2, "tax as adjusted," would be the aggregate of the net amounts included in the subaccounts for each of the three months in the quarterly return period.

No entries need be made on Form 720 in Item 1 or Item 2 of Part 2.

Approval of the above-described method is subject to any changes brought about by future events, such as amendatory legislation.

(Also Part I, Section 7805; 26 CFR 301.7805-1.)

Rev. Proc. 76-46

The purpose of this Revenue Procedure is to publish a list of Revenue Procedures that are no longer applicable to current transactions.

The Revenue Procedure listed below is hereby declared to be obsolete.

Rev. Proc. No.	*C.B. Citation*
57-23	1957-1, 753

Failure to include in this list of Revenue Procedures any other Revenue Procedure should not be taken to imply that such has been determined to have continuing application to future transactions.

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26 CFR 601.602: Forms and instructions. (Also Part I, Sections 117, 4945; 1.117-1, 53.4945-4.)

Rev. Proc. 76-47

SECTION 1. PURPOSE.

A grant by a private foundation to an individual for travel, study, or other similar purpose by such individual is a "taxable expenditure" by the private foundation for purposes of the tax imposed by section 4945 of the Internal Revenue Code of 1954 unless such grant satisfies the requirements of section 4945(g) of the Code. Section 4945(d)(3). Such a grant, awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance, by the Secretary or the Secretary's delegate, may satisfy the requirements of section 4945(g)(1) if it is demonstrated to the satisfaction of the Secretary or the Secretary's delegate that the grant is a scholarship or fellowship grant that is subject to the provisions of section 117(a) and is to be used for study at an educational institution described in section 151(e)(4).

Ruling requests seeking advance approval of procedures are to be submitted to Assistant Commissioner (Employee Plans and Exempt Organizations), Attention: E:EO:T, Washington, D.C. 20224, and should include the statements described in section 53.4945-4(d) of the Foundation Excise Tax Regulations.

The purpose of this Revenue Procedure is to provide guidelines to be used in determining whether a grant made by a private foundation under an employer-related grant program to an employee or to a child of an employee of the particular employer to which the program relates is a scholarship or fellowship grant subject to the provisions of section 117(a) of the Code.

If the private foundation's educational grants are not scholarships or fellowship grants subject to the provisions of section 117(a) of the Code and do not otherwise qualify under the provisions of section 4945(g)(2) or (3), they would be "taxable expenditures" within the meaning of section 4945(d), and might, depending upon the circumstances, lead to a loss of the private foundation's exempt status. As hereinafter explained, grants made by a foundation under an employer-related grant program to employees, or to children of employees, of the particular employer to which the program relates could fail to be section 117 scholarships or fellowship grants because, for example, the purpose of the program is to provide extra compensation, an employment incentive, or an employee fringe benefit for the employees generally or a particular class of employees. Such a purpose would not be consistent with the foundation's exempt purpose or the allowance of deductions under section 170 for contributions to it.

The guidelines are directed only to the foregoing question of qualification under section 117 of the Code. For example, they are not directed to whether the private foundation's employer-related grant program meets the rules of section 53.4945-4(b) of the regulations requiring that the foundation's program be consistent with its exempt status and the allowance of deductions to individuals under section 170 for contributions to the foundation and that the group from which grantees are selected is a "charitable class." The guidelines assume that those requirements have been met except insofar as that conclusion may be affected by the failure of the educational grants to be scholarships or fellowships subject to the provisions of section 117(a) and the reason for such failure.

Thus, for example, these guidelines assume that the group of employees, or children of employees, from which grantees are to be selected is sufficiently broad so that the awarding of grants to members of such a group could be considered consistent with the fulfillment of a purpose described in section 170(c)(2)(B) of the Code and the group could be considered to be a charitable class.

In addition, these guidelines are not directed to whether or not, if programs permit disqualified persons to receive grants, such grants constitute taxable expenditures under section 4945 of the Code or subject the disqualified persons to tax under section 4941.

SEC. 2. APPLICATION OF GUIDELINES.

These guidelines apply to educational grants made on or after January 1, 1970, by a private foundation under an employer-related grant program to individuals who are employees, or the children of employees, of the employer to which the program relates.

An employer-related program is a program that treats some or all of the employees, or children of some or all of the employees, of a particular employer as a group from which grantees of some or all of the foundation's educational grants will be selected, limits the potential grantees for some or all of the foundation's grants to individuals who are employees, or children of employees, of a particular employer,

or otherwise gives such individuals a preference or priority over others in being selected as grantees of such grants.

These guidelines apply only to cases in which the group of employees, or children of employees, of the particular employer to which the program relates, from which grantees are to be selected, is sufficiently broad so that the awarding of grants to members of such a group could be considered consistent with the fulfillment of a purpose described in section 170(c)(2)(B) of the Code and the group could be considered to be a charitable class.

SEC. 3. BACKGROUND.

Section 117 of the Code provides that gross income does not include any amount received as a scholarship or as a fellowship grant at an educational institution (as defined in section 151(e)(4)). Section 1.117-3 of the Income Tax Regulations states that a scholarship generally means an amount paid or allowed to, or for the benefit of, a student to aid that student in pursuing studies. A fellowship grant is defined as an amount paid or allowed to, or for the benefit of, an individual to aid the individual in the pursuit of study or research.

Section 1.117-4(c) of the regulations explains that any amount paid or allowed to, or on behalf of, an individual to enable that individual to pursue studies or research is nevertheless not a scholarship or a fellowship grant for purposes of section 117 of the Code if such amount represents compensation for past, present, or future employment services or if such studies or research are primarily for the benefit of the grantor. In the context of section 1.117-4(c), "benefit" is not limited to monetary gain. See *Jerry S. Turem*, 54 T.C. 1494 (1970). It may include anything that furthers a noneducational purpose of a grantor. By contrast, a grant made for the relatively disinterested purpose of financially assisting an individual to pursue an education for that individual's own benefit may qualify as a section 117 scholarship or fellowship. The determination must, of course, be made in light of all the relevant facts and circumstances.

When educational grants are made available by an employer to its employees on a preferential basis, the employer-employee relationship is immediately suggestive that the grant is compensatory. See *Bingler v. Johnson*, 394 U.S. 741 (1969), 1969-2 C.B. 17. Such preferential grants by an employer to the children of employees suggests a purpose to compensate or otherwise provide an employment incentive to the employee-parents. These suggestions are not dispelled simply because the grantor is an independent third party (for example, a foundation). The employer-related preferential treatment does not, of itself, further in any way the requisite (under section 117 of the Code) disinterested purpose of simply making it financially possible for individuals to obtain an education for their own personal benefit, and suggests the presence of a contrary purpose to provide extra compensation, an employment incentive, or an employee fringe benefit. If a grant program by a private foundation is designed or administered to that end, the grants made under it to the employees or their children will not be scholarships or fellowship grants subject to the provisions of section 117(a).

The Internal Revenue Service will not, however, treat a private foundation's program as designed or administered for such a purpose if the availability of grants to employees of their children fall outside the pattern of employment. In order to be outside the pattern of employment, the availability of grants to employees or their children under the program must be controlled and limited by substantial nonemployment related factors to such an extent that the preferential treatment derived from employment does not continue to be of any significance beyond an initial qualifier. Such qualification must not lead to any significant probability that employment will make grants available for a qualified employee or his or her children interested in applying for one. The Service will treat the grants as scholarships or fellowship grants subject to the provisions of section 117(a) of the Code if (1) the availability of the grants falls outside the pattern of employment, and (2) the grants do not otherwise represent compensation for past, present, or future services rendered or to be rendered the foundation or employer by the employees or their children, and (3) the grants are not for studies or research undertaken primarily for the benefit of the foundation or the employer or for some other purposes not sanctioned by section 117.

SEC. 4. GUIDELINES.

If a private foundation's program satisfies the seven conditions set forth in sections 4.01 through 4.07, below, and meets the percentage test described in section 4.08 applicable to grants to employees' children, or to grants to employees, or to both, as the case may require, the Service will assume the grants awarded under the program to employees, or their children, or to both (if the percentage test is met for each category) will be scholarships or fellowship grants subject to the provisions of section 117(a) of the Code.

If a private foundation's program does not satisfy one or more of the seven conditions set forth in sections 4.01 through 4.07, the Service will not issue a ruling that the grants awarded are scholarships or fellowship grants under section 117 of the Code.

If a private foundation's program satisfies the seven conditions set forth in sections 4.01 through 4.07 below, but does not meet the percentage test of section 4.08 applicable to grants to employees' children or to grants to employees, as the case may be, the question whether the grants, awarded to individuals in the category (children or employees) in respect of which the percentage test was not met, are scholarships or fellowship grants subject to the provisions of section 117(a) of the Code will be determined on the basis

of all the facts and circumstances. In making this determination, the Service will consider as a substitute for the percentage test of section 4.08 all the relevant facts and circumstances to determine whether the primary purpose of the program is to provide extra compensation or other employment incentive, or whether the primary purpose is to educate recipients in their individual capacities. These facts and circumstances will be considered in the context of the probability that a grant will be available to any eligible applicant.

Such relevant facts and circumstances could include the history of the program (such as the source of the program's funding), the courses of study for which the grants are available, any eligibility requirements imposed by the program (other than employment of the applicants or their parents and the age and grade level prerequisites for the studies for which the grants are available), the publicity given the grant program, the degree of independence of the selection committee, the particular standards used for selection, the specific means used to determine whether those standards have been met, the precise nature of the employee limitation or preference, the number of grants available, the number or employees or their children who would be eligible for them, the percentage of eligible employees or their children applying for grants who normally (e.g. on an average basis), receive grants under the program, and whether and how many grants are awarded to individuals who do not qualify as employees or children of employees.

.01 Inducement

The programs must not be used by the employer, the private foundation, or the organizer thereof, to recruit employees or to induce employees to continue their employment or otherwise follow a course of action sought by the employer.

.02 Selection committee

Selection of grant recipients must be made by a committee consisting wholly of individuals totally independent (except for participation on this committee) and separate from the private foundation, its organizer, and the employer concerned. An individual who is a former employee of either the foundation or the employer concerned will not be considered totally independent. Such committees preferably should consist of individuals knowledgeable in the education field so that they have the background and knowledge to properly evaluate the potential of the applicants.

The forwarding of the selections by the independent selection committee to the employer or private foundation for the sole purpose of verifying the eligibility requirements and selection criteria followed by the committee in considering the candidates and in making its selection will not disqualify the program. Any public announcement of the awards, however, must be made by the selection committee or by the foundation.

Grants must be awarded solely in the order recommended by the selection committee. The number of grants to be awarded may be reduced but may not be increased from the number recommended by the selection committee. Only the committee may vary the amounts of the grants awarded.

.03 Eligibility requirements

The program must impose identifiable minimum requirements for grant eligibility. Such requirements must be related to the purpose of the program and in the case of scholarships must limit the independent selection committee's consideration to those employees, or children of employees, who meet the minimum standards for admission to an educational institution (as defined in section 151(e)(4) of the Code) for which the grants are available. No persons will be considered eligible if they would not reasonably be expected to attend such an institution, however, even if they meet such minimum standards.

If an employee must have been employed for some minimum period by the employer to which the program relates to be eligible to receive a grant, or to make that employee's children eligible to receive a grant, the minimum period of employment may not exceed three years. Moreover, eligibility must not be related to any other employment-related factors, such as the employee's position, services, or duties.

.04 Objective basis of selection

Selection of grant recipients must be based solely upon substantial objective standards that are completely unrelated to the employment of the recipients or their parents and to the employer's line of business. Such standards as, but not limited to, prior academic performance, performance on tests designed to measure ability and aptitude for higher education, recommendations from instructors or other individuals not related to the potential awardees, financial need, and conclusions drawn from personal interviews as to motivation and character, may be utilized.

.05 Employment

A grant may not be terminated because the recipient or the recipient's parent terminates employment with the employer subsequent to the awarding of the grant regardless of the reason for such termination of employment.

If a grant is awarded for one academic year and the recipient must reapply for a grant to continue studies for a subsequent year, the recipient may not be considered ineligible for a further grant simply because that individual or the individual's parent is no longer employed by the employer. If a grant is awarded for a period of more than one academic year, subject to renewal, the standards for renewal must be based solely upon nonemployment related factors such as need and maintenance of scholastic standards. Renewal may not be denied because the recipient or parent has previously terminated employment with the employer. In such case, the recipient or parent met the employment requirement at the time the grant was first awarded, and no further employment

requirement can be effected at the time of each renewal.

At the time the grant is awarded or renewed, there must be no requirement, condition or suggestion, express or implied, that the recipient or parent is expected to render future employment services for the foundation or the employer, or be available for such future employment, even though such future employment is at the discretion of the foundation or the employer.

.06 Course of study

The courses of study for which grants are available must not be limited to those that would be of particular benefit to the employer or to the foundation. If the courses of study for which grants are available include one or more that would be of such particular benefit, a grant may not be conditioned on the recipient choosing such a course of study; the recipient must have a free choice to use the grant in the pursuit of a course of study for which the grant is otherwise available that is not of particular benefit to the employer or to the foundation.

.07 Other objectives

The terms of the grant and the courses of study for which grants are available must meet all other requirements of section 117 of the Code and the regulations thereunder, and must be consistent with a disinterested purpose of enabling the recipients to obtain an education in their individual capacities solely for their personal benefit and must not include any commitments, understandings or obligations, conditional or unconditional, suggesting that the studies are undertaken by the recipients for the benefit of the employer or the foundation or have as their objective the accomplishment of any purpose of the employer or the foundation (even though consistent with its exempt status) other than enabling the recipients to obtain an education in their individual capacities and solely for their personal benefit.

.08 Percentage test

In the case of a program that awards grants to children of employees of a particular employer, the program meets the percentage test if the number of grants awarded under that program in any year to such children does not exceed 25 percent of the number of employees' children who, (i) were eligible, (ii) were applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of grants in that year, or 10 percent of the number of employees' children who can be shown to be eligible for grants (whether or not they submitted an application) in that year.

In the case of a program that awards grants to employees of a particular employer, the program meets the percentage test if the number of grants awarded under that program in any year to such employees does not exceed 10 percent of the number of employees who, (i) were eligible, (ii) were applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of grants in that year.

For the purpose of meeting these percentage tests, an employee or child of an employee will be considered eligible only if the individual meets all of the eligibility requirements imposed by the program and such requirements satisfy the conditions of section 4.03 of this Revenue Procedure. Renewals of grants awarded in prior years will not be considered in determining the number of grants awarded in a current year. Grants awarded to children of employees and those awarded to employees will be conisdered as having been awarded under separate programs for purposes of all of the requirements of this Revenue Procedure whether or not they are awarded under separately administered programs.

Social Security Contribution and Benefit Base

Under authority contained in the Social Security Act, as amended by Pub. L. 94-202, 1976-1 C.B. 503, the Secretary, Department of Health, Education, and Welfare has announced (41 F.R. 44878, dated October 13, 1976) the contribution and benefit base with respect to remuneration paid in, and for taxable years beginning in, 1977 shall be $16,500.

TITLE 26.—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER H, PART 601—STATEMENT OF PROCEDURAL RULES

Restoration of Appellate Division authority in certain matters relating to employee plans and exempt organizations.

Preamble

This document contains an amendment to the Statement of Procedural Rules (26 CFR Part 601). The amendment relates to the authority of the Appellate Division in matters relating to employee plans and exempt organizations. It deletes the last sentence of § 601.106(a)(3) (26 CFR Part 601). In addition, a delegation order, to be published separately in the Federal Register, will specifically vest authority to the Appellate Division in certain areas relating to employee plans and exempt organizations.

In accordance with the above discussion, § 601.106(a)(3) (26 CFR Part 601) is hereby amended by deleting the last sentence therefrom.

DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on September 16, 1976, 8:45 a.m., and published in the issue of the Federal Register for September 17, 1976, 41 F.R. 40103)

TITLE 26.—INTERNAL REVENUE.—CHAPTER I, SUBCHAPTER H, PART 601.—STATEMENT OF PROCEDURAL RULES

Rules with respect to public inspection of rulings, determination letters, and technical advice memorandums.

Preamble

This document contains amendments to the Statement of Procedural Rules (26 CFR Part 601). The amendments relate to the procedures to be followed when a person submits a request for a ruling, determination letter, or when technical advice is requested with respect to that person's return in order to facilitate the implementation of section 6110 of the Internal Revenue Code of 1954 which was added by section 1201(a) of the Tax Reform Act of 1976, 90 Stat. 1660 [Pub. L. 94-455]. These rules are applicable to requests for rulings and determination letters postmarked or hand delivered to the Internal Revenue Service after October 31, 1976, and requests for technical advice made by the district director after October 31, 1976, other than requests for determinations to which section 6104 applies.

The admendments set forth the procedures which must be followed when requests are made for rulings, determination letters, or technical advice in order to facilitate compliance by the Internal Revenue Service with the requirements of the new section 6110. The amendments require the person requesting a ruling, determination letter, or about whose return technical advice is sought to make proposals concerning the deletions which new section 6110(c) requires the Internal Revenue Service to make in the text of the documents open to public inspection. Deletions in background file documents proposed by the person requesting a ruling, determination letter, or about whose return technical advice is sought, will not be made nor discussed until requests for inspection thereof are received by the Internal Revenue Service.

The amendments also provide that the person requesting a ruling or determination letter must sign, under penalties of perjury, a declaration that the facts in the request are accurate and complete.

In order to permit the Internal Revenue Service to conform to the requirements of new section 6110 of the Internal Revenue Code, the following amendments to the Statement of Procedural Rules (26 CFR Part 601) are hereby adopted:

Paragraph 1. Paragraph (b)(5) of § 601.105 is amended by redesignating subdivisions (iii)(*e*), (*f*), (*g*), and (*h*) as subdivisions (iii)(*g*), (*h*), (*j*), and (*k*); by revising redesignated subdivision (iii)(*j*) and subdivisions (vi)(*a*), (*c*), (*e*), and (xii)(*b*); and by adding new subdivisions (iii)(*e*), (*f*), (*i*), and (vi)(*f*). The added and revised provisions read as follows:

§ 601.105 Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

* * * * *

(b) *Examination of returns.* * * *

(5) *Technical advice from the National Office* * * *

(iii) *Requesting technical advice* * * *

(*e*)(*1*) In the case of requests for technical advice the taxpayer must also submit, within the 10-day period referred to in (*c*) and (*d*) of this subdivision, whichever applicable (relating to agreement by the taxpayer with the statement of facts submitted in connection with the request for technical advice), the statement described in (*f*) of this subdivision of proposed deletions pursuant to section 6110(c) of the Code. If the statement is not submitted, the taxpayer will be informed by the district director that such a statement is required. If the district director does not receive the statement within 10 days after the taxpayer has been informed of the need for such statement, the district director may decline to submit the request for technical advice. If the district director decides to request technical advice in a case where the taxpayer has not submitted the statement of proposed deletions, the National Office will make those deletions which in the judgement of the Commissioner are required by section 6110(c) of the Code.

(*2*) The requirements included in § 601.105(b)(5) with respect to submissions of statements and other material with respect to proposed deletions to be made from technical advice memoranda before public inspection is permitted to take place do not apply to requests made by the district director before November 1, 1976, or requests for any document to which section 6104 of the Code applies.

(*f*) In order to assist the Internal Revenue Service in making the deletions, required by section 6110(c) of the Code, from the text of technical advice memoranda which are open to public inspection pursuant to section 6110(a) of the Code, there must accompany requests for such technical advice either a statement of the deletions proposed by the taxpayer and the statutory basis for each proposed deletion, or a statement that no information other than names, addresses, and taxpayer identifying numbers need be deleted. Such statements shall be made in a separate document. The statement of proposed deletions shall be accompanied by a copy of all statements of facts and supporting documents which are submitted to the National Office pursuant to (*c*) or (*d*) of this subdivision, on which shall be indicated, by the use of brackets, the material which the taxpayer indicates should be deleted pursuant to section 6110(c) of the Code. The statement of proposed deletions shall indicate the statutory basis, under section 6110(c) of the Code, for each proposed deletion. The statement of proposed deletions shall not appear or be referred to anywhere in the request for technical advice. If the taxpayer decides to request additional deletions pursuant to section 6110(c) of the Code prior to the time the National Office replies to the request for technical advice, additional statements may be submitted.

* * * * *

(i) Generally, prior to replying to the request for technical advice, the National Office shall inform the taxpayer orally or in writing of the mate-

rial likely to appear in the technical advice memorandum which the taxpayer proposed be deleted but which the Internal Revenue Service determined should not be deleted. If so informed, the taxpayer may submit within 10 days any further information, arguments or other material in support of the position that such material be deleted. The Internal Revenue Service will attempt, if feasible, to resolve all disagreements with respect to proposed deletions prior to the time the National Office replies to the request for technical advice. However, in no event shall the taxpayer have the right to a conference with respect to resolution of any disagreements concerning material to be deleted from the text of the technical advice memorandum, but such matters may be considered at any conference otherwise scheduled with respect to the request.

(*j*) The provisions of (*a*) through (*i*) of this subdivision, relating to the referral of issues upon request of the taxpayer, advising taxpayers of the referral of issues, the submission of proposed deletions, and the granting of conferences in the National Office, are not applicable to technical advice memoranda described in section 6110 (g) (5) (A) of the Code, relating to cases involving criminal or civil fraud investigations and jeopardy or termination assessments. However, in such cases the taxpayer shall be allowed to provide the statement of proposed deletions to the National Office upon the completion of all proceedings with respect to the investigations or assessments, but prior to the date on which the Commissioner mails the notice pursuant to section 6110(f) (1) of the Code of intention to disclose the technical advice memorandum.

* * * * *

(vi) *Preparation of technical advice memorandum by the National Office.* (*a*) Immediately upon receipt in the National Office, the technical employee to whom the case is assigned will analyze the file to ascertain whether it meets the requirements of subdivision (iii) of this subparagraph. If the case is not complete with respect to any requirement in subdivision (iii) (*a*) through (*d*) of this subparagraph, appropriate steps will be taken to complete the file. If any request for technical advice does not comply with the requirements of subdivision (iii) (*e*) of this subparagraph, relating to the statement of proposed deletions, the National Office will make those deletions from the technical advice memorandum which in the judgement of the Commissioner are required by section 6110(c) of the Code.

* * * * *

(*c*) Replies to requests for technical advice will be addressed to the district director and will be drafted in two parts. Each part will identify the taxpayer by name, address, identification number, and year or years involved. The first part (hereafter called the "Technical Advice Memorandum") will contain (*1*) a recitation of the pertinent facts having a bearing on the issue; (*2*) a discussion of the facts, precedents, and reasoning of the National Office; and (*3*) the conclusions of the National Office. The conclusions will give direct answers, whenever possible, to the specific questions of the district office. The discussion of the issues will be in such detail that the district officials are apprised of the reasoning underlying the conclusion. There shall accompany the technical advice memorandum a notice pursuant to section 6110(f) (1) of the Code of intention to disclose the technical advice memorandum (including a copy of the version proposed to be open to public inspection and notations of third party communications pursuant to section 6110(d) of the Code) which the district director shall forward to the taxpayer at such time that the district director furnishes a copy of the technical advice memorandum to the taxpayer pursuant to (*e*) of this subdivision.

* * * * *

(*e*) It is the general practice of the Service to furnish a copy of the technical advice memorandum to the taxpayer after it has been adopted by the district director. However, in the case of technical advice memoranda described in section 6110(g) (5) (A) of the Code, relating to cases involving criminal or civil fraud investigations and jeopardy or termination assessments, a copy of the technical advice memorandum shall not be furnished the taxpayer until all proceedings with respect to the investigations or assessments are completed.

(*f*) After receiving the notice pursuant to section 6110(f) (1) of the Code of intention to disclose the technical advice memorandum, if the taxpayer desires to protest the disclosure of certain information in the technical advice memorandum, the taxpayer must within 20 days submit a written statement identifying those deletions not made by the Internal Revenue Service which the taxpayer believes should have been made. The taxpayer shall also submit a copy of the version of the technical advice memorandum proposed to be open to public inspection on which the taxpayer indicates, by the use of brackets, the deletions proposed by the taxpayer but which have not been made by the Internal Revenue Service. Generally, the Internal Revenue Service will not consider the deletion under this subparagraph of any material which the taxpayer did not, prior to the time when the National Office sent its reply to the request for technical advice to the district director, propose be deleted. The Internal Revenue Service shall, within 20 days after receipt of the response by the taxpayer to the notice pursuant to section 6110(f) (1) of the Code, mail to the taxpayer its final administrative conclusion with respect to the deletions to be made.

(vii) *Action on technical advice in district offices.* * * *

(*b*) The district director will furnish to the taxpayer a copy of the technical advice memorandum described in subdivision (vi) (*c*) of this subparagraph and the notice pursuant to section 6110(f) (1) of the Code of inten-

tion to disclose the technical advice memorandum (including a copy of the version proposed to be open to public inspection and notations of third party communications pursuant to section 6110(d) of the Code). The preceding sentence shall not apply to technical advice memoranda involving civil fraud or criminal investigations, or jeopardy or termination assessments, as described in subdivision (iii) (*j*) of this subparagraph or to documents to which section 6104 of the Code applies.

* * * * *

Par. 2. Paragraph (e) of § 601.201 is amended by redesignating subparagraphs (5) through (9) as subparagraphs (6) through (10), subparagraphs (10) through (13) as subparagraphs (12) through (15), and subparagraphs (14) and (15) as subparagraphs (18) and (19), by revising subparagraphs (1), (2), and redesignated subparagraph (9), and by adding new subparagraphs (5), (11), (16), and (17). These added and revised provisions read as follows:

§ 601.201 Rulings and determination letters.

* * * * *

(e) *Instructions to taxpayers.* (1) A request for a ruling or a determination letter is to be submitted in duplicate if (i) more than one issue is presented in the request or (ii) a closing agreement is requested with respect to the issue presented. There shall accompany the request a declaration, signed by the person or persons by whom or on whose behalf the request for a ruling or determination letter is postmarked or hand delivered to the Internal Revenue Service after October 31, 1976, in the following form: "Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the requested ruling or determination letter are true, correct, and complete".

(2) * * * In the case of requests for rulings or determination letters, other than those to which section 6104 of the Code applies, postmarked or hand delivered to the Internal Revenue Service after October 31, 1976, there must accompany such requests a statement, described in subparagraph (5) of this paragraph, of proposed deletions pursuant to section 6110(c) of the Code. Such statement is not required if the request is to secure the consent of the Commissioner with respect to the adoption of or change in accounting or funding periods or methods pursuant to sections 412, 442, 446(e), or 706 of the Code, in which case the procedures described in § 601.204(d) will be followed.

* * * * *

(5) In order to assist the Internal Revenue Service in making the deletions, required by section 6110(c) of the Code, from the text of rulings and determination letters, which are open to public inspection pursuant to section 6110(a) of the Code, there must accompany requests for such rulings or determination letters either a statement of the deletions proposed by the person requesting the ruling or determination letter and the statutory basis for each proposed deletion, or a statement that no information other than names, addresses, and taxpayer identifying numbers need be deleted. Such statement shall be made in a separate document. The statement of proposed deletions shall be accompanied by a copy of the request for a ruling or determination letter and supporting documents, on which shall be indicated, by the use of brackets, the material which the person making such request indicates should be deleted pursuant to section 6110(c) of the Code. The statement of proposed deletions shall indicate the statutory basis, under section 6110(c) of the Code, for each proposed deletion. The statement of proposed deletions shall not appear or be referred to anywhere in the request for a ruling or determination letter. If the person making the request decides to request additional deletions pursuant to section 6110(c) of the Code prior to the time the ruling or determination letter is issued, additional statements may be submitted.

* * * * *

(9) Any request for a ruling or determination letter that does not comply with all the provisions of this paragraph will be acknowledged, and the requirements that have not been met will be pointed out. If a request for a ruling lacks essential information, the taxpayer or his represenetative will be advised that if the information is not forthcoming within 30 days, the request will be closed. If the information is received after the request is closed, the request will be reopened and treated as a new request as of the date of the receipt of the essential information. Priority treatment of such request will be granted only in rare cases upon the approval of the division director.

* * * * *

(11) Generally, prior to issuing the ruling or determination letter, the National Office or district director shall inform the person requesting such ruling or determination letter orally or in writing of the material likely to appear in the ruling or determination letter which such person proposed be deleted but which the Internal Revenue Service determines should not be deleted. If so informed, the person requesting the ruling or determination letter may submit within 10 days any further information, arguments or other material in support of the position that such material be deleted. The Internal Revenue Service will attempt, if feasible, to resolve all disagreements with respect to proposed deletions prior to the issuance of the ruling or determination letter. However, in no event shall the person requesting the ruling or determination letter have the right to a conference with respect to resolution of any disagreements concerning material to be deleted from the text of the ruling or determination letter, but such matters may be con-

sidered at any conference otherwise scheduled with respect to the request.

* * * * *

(16) After receiving the notice pursuant to section 6110(f)(1) of the Code of intention to disclose the ruling or determination letter (including a copy of the version proposed to be open to public inspection and notations of third-party communications pursuant to section 6110(d) of the Code), if the person requesting the ruling or determination letter desires to protest the disclosure of certain information in the ruling or determination letter, such person must within 20 days submit a written statement identifying those deletions not made by the Internal Revenue Service which such person believes should have been made. Such person shall also submit a copy of the version of the ruling or determination letter proposed to be open to public inspection on which such person indicates, by the use of brackets, the deletions proposed by the taxpayer but which have not been made by the Internal Revenue Service. Generally, the Internal Revenue Service will not consider the deletion under this subparagraph of any material which the taxpayer did not, prior to the issuance of the ruling or determination letter, propose be deleted. The Internal Revenue Service shall, within 20 days after receipt of the response by the person requesting the ruling or determination letter to the notice pursuant to section 6110(f)(1) of the Code, mail to such person its final administrative conclusion with respect to the deletions to be made.

(17) After receiving the notice pursuant to section 6110(f)(1) of the Code of intention to disclose (but no later than 60 days after such notice is mailed), the person requesting a ruling or determination letter may submit a request for delay of public inspection pursuant to either section 6110(g)(3) or section 6110(g)(3) and (4) of the Code. The request for delay shall be submitted to the office to which the request for a ruling or determination letter was submitted. A request for delay shall contain the date on which it is expected that the underlying transaction will be completed. The request for delay pursuant to section 6110(g)(4) of the Code shall contain a statement from which the Commissioner may determine that good cause exists to warrant such delay.

* * * * *

Par. 3. Section 601.204 is amended by adding a new paragraph (d). This added provision reads as follows:

§ 601.204 Changes in accounting periods and in methods of accounting.

* * * * *

(d) *Instructions to taxpayers.* The person seeking to secure the consent of the Commissioner with respect to a change of accounting periods or methods pursuant to section 442 or 446(e) of the Code need not submit the statement of proposed deletions described in § 601.201(e)(5) at the time the request is made. If, however, the person seeking such consent is informed by the National Office that the resulting ruling will be open to public inspection pursuant to section 6110 of the Code, the statement of proposed deletions must be submitted within 20 days after such person has been so informed.

Par. 4. Section 601.701(b)(2) is amended by revising subdivision (vi), by redesignating subdivision (vi) as subdivision (vii), and by adding a new subdivision (vi). These added and amended provisions read as follows:

§ 601.701. Publicity of information.

* * * * *

(b) *Exemptions*—(1) *In general.* * * *

(2) *Matters specifically exempted from disclosure by statute.* * * *

(v) Section 6108, relating to the publication of statistics of income;

(vi) Section 6110, relating to public inspection of written determinations; and

(vii) Section 7213, relating to penalties for unauthorized disclosure of information by Federal officers or employees or other persons.

* * * * *

Par. 5. Section 601.702 is amended by adding a sentence immediately after the fifth sentence in the flush material of paragraph (b)(1), by adding a new subparagraph (11) to paragraph (d), by redesignating subparagraphs (6) and (7) of paragraph (f) as subparagraph (6) to paragraph (f). These added and revised provisions read as follows:

§ 601.702 Publication and public inspection.

* * * * *

(b) *Public inspection and copying*—(1) *In general.* * * * Rulings, determination letters, and technical advice memorandums are open to public inspection and copying pursuant to section 6110 of the Code and not pursuant to 5 U.S.C. 552. * * *

* * * * *

(d) *Rules for disclosure of certain specified matters.* * * *

(11) *Public inspection of written determinations.* Certain rulings, determination letters, and technical advice memorandums are open to public inspection pursuant to section 6110 of the Code.

* * * * *

(f) *Fees for services.* * * *

* * * * *

(6) *Search and deletion services with respect to records open to public inspection pursuant to section 6110 of the Code.* Fees charged for searching for and making deletions in records open to public inspection pursuant to section 6110 of the Code only upon written request shall be at actual cost, as the Commissioner may from time to time establish.

* * * * *

DONALD C. ALEXANDER,

Commissioner of Internal Revenue.

(Filed by the Office of the Federal Regis-

ter on November 3, 1976, 4:26 p.m., and published in the issue of the Federal Register for November 5, 1976, 41 F.R. 48740)

TITLE 26—INTERNAL REVENUE—CHAPTER I, SUBCHAPTER A, PART 1—INCOME TAX, TAXABLE YEAR BEGINNING AFTER DECEMBER 31, 1953

Merchant marine and fisheries capital construction funds—Notice of applicable rates of interest on nonqualified withdrawals.

Pursuant to authority contained in section 607(h)(4) of the Merchant Marine Act, 1936 (46 U.S.C. 1101), as amended by section 21 of the Merchant Marine Act of 1970 (84 Stat. 1031) [Pub. L. 91-469, 1970-2 C.B. 372], we hereby determine and announce that the applicable rate of interest on the amount of additional tax attributable to any nonqualified withdrawal from a capital construction fund established under section 607 of the Act shall be, with respect to nonqualified withdrawals made in a taxable year beginning in—

1970	8.00%
1971	8.00%
1972	6.46%
1973	6.45%
1974	7.46%
1975	8.47%
1976	8.44%

The determination of the applicable rate of interest with respect to nonqualified withdrawals made in a taxable year beginning after 1971 was computed in accordance with the joint regulations promulgated under the Act (26 CFR Part 3, § 3.7(e)(2)(ii)) by multiplying 8 percent by the ratio which (a) the average yield on 5 year Treasury securities for the calendar year immediately preceding the beginning of such taxable year, bears to (b) the average yield on 5 year Treasury securities for the calendar year 1970. The applicable rate so determined was computed to the nearest one-hundredth of 1 percent.

Dated July 1, 1976.

R. W. WHITE,
Administrator, National Oceanic and Atmospheric Administration.

ROBERT J. BLACKWELL,
Assistant Secretary of Commerce for Maritime Affairs.

WILLIAM M. GOLDSTEIN,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 9, 1976, 8:45 a.m.; and published in the issue of the Federal Register for July 12, 1976, 41 F.R. 28565)

Treasury Department Order 150-85

Office of Assistant Commissioner (Data Services)

By virtue of the authority vested in me by Reorganization Plan No. 26 of 1950:

(1) There shall be in the National Office of the Internal Revenue Service the Office of Assistant Commissioner (Data Services).

(2) Approval is given to the transfer of such personnel, records, equipment, and funds as are determined by the Commissioner of Internal Revenue and the Assistant Secretary for Administration to be appropriate in connection therewith.

This order shall become effective upon such date as the Commissioner of Internal Revenue may determine.

Dated: November 5, 1976.

WILLIAM E. SIMON,
Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 15, 1976, 8:45 a.m., and published in the issue of the Federal Register for November 16, 1976, 41 F.R. 50523)

Announcement of the Disbarment, Suspension, or Consent To Voluntary Suspension of Attorneys, Certified Public Accountants and Enrolled Agents From Practice Before The Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant or enrolled agent, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, or enrolled agent in accordance with the consent offered.

Attorneys, certified public accountants and enrolled agents are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants and enrolled agents to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have entered consent suspensions from such practice, their designation as attorney, certified public accountant or enrolled agent, and the date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive

weeks or for as many weeks as is practicable for each attorney, certified public accountant or enrolled agent so suspended and will later be consolidated and published in the Cumulative Bulletin.

The following persons have entered consent suspensions from practice before the Internal Revenue Service:

Name	Address	Designation	Term of Suspension
Jordan C. Pappas	Morgantown, West Virginia	Attorney	Six months commencing June 15, 1976
Andrew M. Pinckney	Albany, New York	Attorney	Indefinite from June 17, 1976
Marcus R. Lindsay	Corpus Christi, Texas	Certified Public Accountant	For six months commencing June 29, 1976
Julius Weinberg	Philadelphia, Pa.	Certified Public Accountant	Indefinite from July 15, 1976
Jerome Weber	Beverly Hills, Cal.	Attorney	Indefinite from July 26, 1976
Mildred L. Winkels	Thousand Oaks, Cal.	Enrolled Agent	Indefinite from August 4, 1976
Harry A. Burglass	Metairie, Louisiana	Attorney	Indefinite from August 9, 1976
James A. Thomas	Birmingham, Alabama	Enrolled Agent	Indefinite from August 20, 1976
Albert M. Resnick	New York, N.Y.	Certified Public Accountant	Indefinite from September 1, 1976
William S. Williford, Jr.	Chester, S.C.	Enrolled Agent	Four Months from September 1, 1976
Julius O. Spradley	Chester, S.C.	Enrolled Agent	Four Months from September 1, 1976
Bernard Kaufman	New York, N.Y.	Certified Public Accountant	Indefinite from September 15, 1976
Daniel H. Breslow	New York, N.Y.	Certified Public Accountant	Indefinite from September 20, 1976
Ivan E. Grondin	Fairbanks, Alaska	Certified Public Accountant	Indefinite from November 2, 1976
Richard C. Kielblock	Minneapolis, Minn.	Certified Public Accountant	Indefinite from November 10, 1976
Seymour Schneidman	New York, New York	Certified Public Accountant	Indefinite from December 1, 1976

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The abbreviation and number in parentheses following the index entry refer to the specific item; numbers following the parentheses refer to the page number on which it appears.

Key to Abbreviations:

RR Revenue Ruling
RP Revenue Procedure
TD Treasury Decision
CD Court Decision
PL Public Law
EO Executive Order
DO Delegation Order
TDO Treasury Department Order
TC Tax Convention
SPR State of Procedural Rules
PTE Prohibited Transaction Exemption

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