INTERNAL REVENUE CODE OF 1954

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PUBLIC LAW 591 - CHAPTER 736

APPROVED AUGUST 16, 1954, 9:45 a. m., E. D. T.

H. R. 8300

Internal Revenue Code of 1954

ENACTED DURING THE

SECOND SESSION OF THE EIGHTY-THIRD CONGRESS

OF THE UNITED STATES OF AMERICA

Begun and held at the City of Washington on Wednesday, January 6, 1954.

An Act

To revise the internal revenue laws of the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) CITATION.—

(1) The provisions of this Act set forth under the heading "Internal Revenue Title" may be cited as the "Internal Revenue Code of 1954".

(2) The Internal Revenue Code enacted on February 10, 1939, as amended, may be cited as the "Internal Revenue Code of 1939".

(b) PUBLICATION.—This Act shall be published as volume 68A of the United States Statutes at Large, with a comprehensive table of contents and an appendix; but without an index or marginal references. The date of enactment, bill number, public law number, and chapter number, shall be printed as a headnote.

(c) CROSS REFERENCE.—For saving provisions, effective date provisions, and other related provisions, see chapter 80 (sec. 7801 and following) of the Internal Revenue Code of 1954.

(d) ENACTMENT OF INTERNAL REVENUE TITLE INTO LAW.—The Internal Revenue Title referred to in subsection (a) (1) is as follows:

INTERNAL REVENUE TITLE

SUBTITLE A. Income taxes.
SUBTITLE B. Estate and gift taxes.
SUBTITLE C. Employment taxes.
SUBTITLE D. Miscellaneous excise taxes.
SUBTITLE E. Alcohol, tobacco, and certain other excise taxes.
SUBTITLE F. Procedure and administration.
SUBTITLE G. The Joint Committee on Internal Revenue Taxation.

Subtitle A—Income Taxes

CHAPTER 1. Normal taxes and surtaxes.
CHAPTER 2. Tax on self-employment income.
CHAPTER 3. Withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds.
CHAPTER 4. Rules applicable to recovery of excessive profits on government contracts.
CHAPTER 5. Tax on transfers to avoid income tax.
CHAPTER 6. Consolidated returns.

CHAPTER 1—NORMAL TAXES AND SURTAXES

SUBCHAPTER A. Determination of tax liability.
SUBCHAPTER B. Computation of taxable income.
SUBCHAPTER C. Corporate distributions and adjustments.
SUBCHAPTER D. Deferred compensation, etc.
SUBCHAPTER E. Accounting periods and methods of accounting.
SUBCHAPTER F. Exempt organizations.
SUBCHAPTER G. Corporations used to avoid income tax on shareholders.
SUBCHAPTER H. Banking institutions.
SUBCHAPTER I. Natural resources.
SUBCHAPTER J. Estates, trusts, beneficiaries, and decedents.
SUBCHAPTER K. Partners and partnerships.
SUBCHAPTER L. Insurance companies.
SUBCHAPTER M. Regulated investment companies.
SUBCHAPTER N. Tax based on income from sources within or without the United States.
SUBCHAPTER O. Gain or loss on disposition of property.
SUBCHAPTER P. Capital gains and losses.
SUBCHAPTER Q. Readjustment of tax between years and special limitations.
SUBCHAPTER R. Election of certain partnerships and proprietorships as to taxable status.

Subchapter A—Determination of Tax Liability

Part I. Tax on individuals.
Part II. Tax on corporations.
Part III. Changes in rates during a taxable year.
Part IV. Credits against tax.

PART I—TAX ON INDIVIDUALS

Sec. 1. Tax imposed.
Sec. 2. Tax in case of joint return or return of surviving spouse.
Sec. 3. Optional tax if adjusted gross income is less than $5,000.
Sec. 4. Rules for optional tax.
Sec. 5. Cross references relating to tax on individuals.

SEC. 1. TAX IMPOSED.

(a) RATES OF TAX ON INDIVIDUALS.—A tax is hereby imposed for each taxable year on the taxable income of every individual other than a head of a household to whom subsection (b) applies. The amount of the tax shall be determined in accordance with the following table:

If the taxable income is:	The tax is:
Not over $2,000	20% of the taxable income.
Over $2,000 but not over $4,000	$400, plus 22% of excess over $2,000.
Over $4,000 but not over $6,000	$840, plus 26% of excess over $4,000.
Over $6,000 but not over $8,000	$1,360, plus 30% of excess over $6,000.
Over $8,000 but not over $10,000	$1,960, plus 34% of excess over $8,000.
Over $10,000 but not over $12,000	$2,640, plus 38% of excess over $10,000.
Over $12,000 but not over $14,000	$3,400, plus 43% of excess over $12,000.
Over $14,000 but not over $16,000	$4,260, plus 47% of excess over $14,000.
Over $16,000 but not over $18,000	$5,200, plus 50% of excess over $16,000.
Over $18,000 but not over $20,000	$6,200, plus 53% of excess over $18,000.
Over $20,000 but not over $22,000	$7,260, plus 56% of excess over $20,000.
Over $22,000 but not over $26,000	$8,380, plus 59% of excess over $22,000.
Over $26,000 but not over $32,000	$10,740, plus 62% of excess over $26,000.
Over $32,000 but not over $38,000	$14,460, plus 65% of excess over $32,000.
Over $38,000 but not over $44,000	$18,360, plus 69% of excess over $38,000.
Over $44,000 but not over $50,000	$22,500, plus 72% of excess over $44,000.
Over $50,000 but not over $60,000	$26,820, plus 75% of excess over $50,000.
Over $60,000 but not over $70,000	$34,320, plus 78% of excess over $60,000.
Over $70,000 but not over $80,000	$42,120, plus 81% of excess over $70,000.
Over $80,000 but not over $90,000	$50,220, plus 84% of excess over $80,000.
Over $90,000 but not over $100,000	$58,620, plus 87% of excess over $90,000.
Over $100,000 but not over $150,000	$67,320, plus 89% of excess over $100,000.
Over $150,000 but not over $200,000	$111,820, plus 90% of excess over $150,000.
Over $200,000	$156,820, plus 91% of excess over $200,000.

(b) RATES OF TAX ON HEADS OF HOUSEHOLDS.—

(1) RATES OF TAX.—A tax is hereby imposed for each taxable year on the taxable income of every individual who is the head of a household. The amount of the tax shall be determined in accordance with the following table:

If the taxable income is:	The tax is:
Not over $2,000	20% of the taxable income.
Over $2,000 but not over $4,000	$400, plus 21% of excess over $2,000.
Over $4,000 but not over $6,000	$820, plus 24% of excess over $4,000.
Over $6,000 but not over $8,000	$1,300, plus 26% of excess over $6,000.
Over $8,000 but not over $10,000	$1,820, plus 30% of excess over $8,000.
Over $10,000 but not over $12,000	$2,420, plus 32% of excess over $10,000.
Over $12,000 but not over $14,000	$3,060, plus 36% of excess over $12,000.
Over $14,000 but not over $16,000	$3,780, plus 39% of excess over $14,000.
Over $16,000 but not over $18,000	$4,560, plus 42% of excess over $16,000.
Over $18,000 but not over $20,000	$5,400, plus 43% of excess over $18,000.
Over $20,000 but not over $22,000	$6,260, plus 47% of excess over $20,000.
Over $22,000 but not over $24,000	$7,200, plus 49% of excess over $22,000.
Over $24,000 but not over $28,000	$8,180, plus 52% of excess over $24,000.
Over $28,000 but not over $32,000	$10,260, plus 54% of excess over $28,000.
Over $32,000 but not over $38,000	$12,420, plus 58% of excess over $32,000.
Over $38,000 but not over $44,000	$15,900, plus 62% of excess over $38,000.
Over $44,000 but not over $50,000	$19,620, plus 66% of excess over $44,000.
Over $50,000 but not over $60,000	$23,580, plus 68% of excess over $50,000.
Over $60,000 but not over $70,000	$30,380, plus 71% of excess over $60,000.
Over $70,000 but not over $80,000	$37,480, plus 74% of excess over $70,000.
Over $80,000 but not over $90,000	$44,880, plus 76% of excess over $80,000.
Over $90,000 but not over $100,000	$52,480, plus 80% of excess over $90,000.
Over $100,000 but not over $150,000	$60,480, plus 83% of excess over $100,000.
Over $150,000 but not over $200,000	$101,980, plus 87% of excess over $150,000.
Over $200,000 but not over $300,000	$145,480, plus 90% of excess over $200,000.
Over $300,000	$235,480, plus 91% of excess over $300,000.

(2) DEFINITION OF HEAD OF HOUSEHOLD.—For purposes of this subtitle, an individual shall be considered a head of a household if, and only if, such individual is not married at the close of his taxable year, is not a surviving spouse (as defined in section 2 (b)), and either—

(A) maintains as his home a household which constitutes for such taxable year the principal place of abode, as a member of such household, of—

(i) a son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer, but if such son, stepson, daughter, stepdaughter, or descendant is married at the close of the taxpayer's taxable year, only if the taxpayer is entitled to a deduction for the taxable year for such person under section 151, or

(ii) any other person who is a dependent of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such person under section 151, or

(B) maintains a household which constitutes for such taxable year the principal place of abode of the father or mother of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such father or mother under section 151.

For purposes of this paragraph and of section 2 (b) (1) (B), an individual shall be considered as maintaining a household only if over half of the cost of maintaining the household during the taxable year is furnished by such individual.

(3) DETERMINATION OF STATUS.—For purposes of this subsection—

(A) a legally adopted child of a person shall be considered a child of such person by blood;

(B) an individual who is legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married;

(C) a taxpayer shall be considered as not married at the close of his taxable year if at any time during the taxable year his spouse is a nonresident alien; and

(D) a taxpayer shall be considered as married at the close of his taxable year if his spouse (other than a spouse described in subparagraph (C)) died during the taxable year.

(4) LIMITATIONS.—Notwithstanding paragraph (2), for purposes of this subtitle a taxpayer shall not be considered to be a head of a household—

(A) if at any time during the taxable year he is a nonresident alien; or

(B) by reason of an individual who would not be a dependent for the taxable year but for—

(i) paragraph (9) of section 152 (a),

(ii) paragraph (10) of section 152 (a), or

(iii) subsection (c) of section 152.

(c) SPECIAL RULES.—The tax imposed by subsection (a), and the tax imposed by paragraph (1) of subsection (b), consists of—

(1) a normal tax of 3 percent of the taxable income, and

(2) a surtax equal to (A) the amount determined in accordance with the table in subsection (a) or paragraph (1) of subsection (b), minus (B) the normal tax.

The tax shall in no event exceed 87 percent of the taxable income for the taxable year.

(d) CROSS REFERENCE.—

For definition of taxable income, see section 63.

SEC. 2. TAX IN CASE OF JOINT RETURN OR RETURN OF SURVIVING SPOUSE.

(a) RATE OF TAX.—In the case of a joint return of a husband and wife under section 6013, the tax imposed by section 1 shall be twice the tax which would be imposed if the taxable income were cut in half. For purposes of this subsection and section 3, a return of a surviving spouse (as defined in subsection (b)) shall be treated as a joint return of a husband and wife under section 6013.

(b) DEFINITION OF SURVIVING SPOUSE.—

(1) IN GENERAL.—For purposes of subsection (a), the term "surviving spouse" means a taxpayer—

(A) whose spouse died during either of his two taxable years immediately preceding the taxable year, and

(B) who maintains as his home a household which constitutes for the taxable year the principal place of abode (as a member of such household) of a dependent (i) who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer, and (ii) with respect to whom the taxpayer is entitled to a deduction for the taxable year under section 151.

(2) LIMITATIONS.—Notwithstanding paragraph (1), for purposes of subsection (a) a taxpayer shall not be considered to be a surviving spouse—

(A) if the taxpayer has remarried at any time before the close of the taxable year, or

(B) unless, for the taxpayer's taxable year during which his spouse died, a joint return could have been made under the provisions of section 6013 (without regard to subsection (a) (3) thereof) or under the corresponding provisions of the Internal Revenue Code of 1939.

SEC. 3. OPTIONAL TAX IF ADJUSTED GROSS INCOME IS LESS THAN $5,000.

In lieu of the tax imposed by section 1, there is hereby imposed for each taxable year, on the taxable income of each individual whose adjusted gross income for such year is less than $5,000 and who has elected for such year to pay the tax imposed by this section, the tax shown in the following table:

If adjusted gross income is—		And the number of exemptions is—				If adjusted gross income is—		And the number of exemptions is—												
								1		2			3							
At least	But less than	1	2	3	4 or more	At least	But less than	And taxpayer is single or married filing separately	And taxpayer is head of household	And taxpayer is single or married filing separately	And taxpayer is head of household	And a joint return is filed	And taxpayer is single or married filing separately	And taxpayer is head of household	And a joint return is filed	4	5	6	7	8 or more
		The tax is—						The tax is—												
$0	$675	$0	$0	$0	$0	$2,325	$2,350	$301	$301	$181	$181	$181	$61	$61	$61	$0	$0	$0	$0	$0
675	700	4	0	0	0	2,350	2,375	305	305	185	185	185	65	65	65	0	0	0	0	0
700	725	8	0	0	0	2,375	2,400	310	310	190	190	190	70	70	70	0	0	0	0	0
725	750	13	0	0	0	2,400	2,425	314	314	194	194	194	74	74	74	0	0	0	0	0
750	775	17	0	0	0	2,425	2,450	319	319	199	199	199	79	79	79	0	0	0	0	0
775	800	22	0	0	0	2,450	2,475	323	323	203	203	203	83	83	83	0	0	0	0	0
800	825	26	0	0	0	2,475	2,500	328	328	208	208	208	88	88	88	0	0	0	0	0
825	850	31	0	0	0	2,500	2,525	332	332	212	212	212	92	92	92	0	0	0	0	0
850	875	35	0	0	0	2,525	2,550	337	337	217	217	217	97	97	97	0	0	0	0	0
875	900	40	0	0	0	2,550	2,575	341	341	221	221	221	101	101	101	0	0	0	0	0
900	925	44	0	0	0	2,575	2,600	346	346	226	226	226	106	106	106	0	0	0	0	0
925	950	49	0	0	0	2,600	2,625	350	350	230	230	230	110	110	110	0	0	0	0	0
950	975	53	0	0	0	2,625	2,650	355	355	235	235	235	115	115	115	0	0	0	0	0
975	1,000	58	0	0	0	2,650	2,675	359	359	239	239	239	119	119	119	0	0	0	0	0
1,000	1,025	62	0	0	0	2,675	2,700	364	364	244	244	244	124	124	124	4	0	0	0	0
1,025	1,050	67	0	0	0	2,700	2,725	368	368	248	248	248	128	128	128	8	0	0	0	0
1,050	1,075	71	0	0	0	2,725	2,750	373	373	253	253	253	133	133	133	13	0	0	0	0
1,075	1,100	76	0	0	0	2,750	2,775	377	377	257	257	257	137	137	137	17	0	0	0	0
1,100	1,125	80	0	0	0	2,775	2,800	382	382	262	262	262	142	142	142	22	0	0	0	0
1,125	1,150	85	0	0	0	2,800	2,825	386	386	266	266	266	146	146	146	26	0	0	0	0
1,150	1,175	89	0	0	0	2,825	2,850	391	391	271	271	271	151	151	151	31	0	0	0	0
1,175	1,200	94	0	0	0	2,850	2,875	395	395	275	275	275	155	155	155	35	0	0	0	0
1,200	1,225	98	0	0	0	2,875	2,900	400	400	280	280	280	160	160	160	40	0	0	0	0
1,225	1,250	103	0	0	0	2,900	2,925	405	404	284	284	284	164	164	164	44	0	0	0	0
1,250	1,275	107	0	0	0	2,925	2,950	410	409	289	289	289	169	169	169	49	0	0	0	0
1,275	1,300	112	0	0	0	2,950	2,975	415	414	293	293	293	173	173	173	53	0	0	0	0
1,300	1,325	116	0	0	0	2,975	3,000	420	419	298	298	298	178	178	178	58	0	0	0	0
1,325	1,350	121	1	0	0	3,000	3,050	427	426	305	305	305	185	185	185	65	0	0	0	0
1,350	1,375	125	5	0	0	3,050	3,100	437	435	314	314	314	194	194	194	74	0	0	0	0
1,375	1,400	130	10	0	0	3,100	3,150	447	445	323	323	323	203	203	203	83	0	0	0	0
1,400	1,425	134	14	0	0	3,150	3,200	457	454	332	332	332	212	212	212	92	0	0	0	0
1,425	1,450	139	19	0	0	3,200	3,250	467	464	341	341	341	221	221	221	101	0	0	0	0
1,450	1,475	143	23	0	0	3,250	3,300	476	473	350	350	350	230	230	230	110	0	0	0	0
1,475	1,500	148	28	0	0	3,300	3,350	486	482	359	359	359	239	239	239	119	0	0	0	0
1,500	1,525	152	32	0	0	3,350	3,400	496	492	368	368	368	248	248	248	128	8	0	0	0
1,525	1,550	157	37	0	0	3,400	3,450	506	501	377	377	377	257	257	257	137	17	0	0	0
1,550	1,575	161	41	0	0	3,450	3,500	516	511	386	386	386	266	266	266	146	26	0	0	0
1,575	1,600	166	46	0	0	3,500	3,550	526	520	395	395	395	275	275	275	155	35	0	0	0
1,600	1,625	170	50	0	0	3,550	3,600	536	530	404	404	404	284	284	284	164	44	0	0	0
1,625	1,650	175	55	0	0	3,600	3,650	546	539	414	413	413	293	293	293	173	53	0	0	0
1,650	1,675	179	59	0	0	3,650	3,700	556	549	424	423	422	302	302	302	182	62	0	0	0
1,675	1,700	184	64	0	0	3,700	3,750	566	558	434	432	431	311	311	311	191	71	0	0	0
1,700	1,725	188	68	0	0	3,750	3,800	575	567	443	441	440	320	320	320	200	80	0	0	0
1,725	1,750	193	73	0	0	3,800	3,850	585	577	453	451	449	329	329	329	209	89	0	0	0
1,750	1,775	197	77	0	0	3,850	3,900	595	586	463	460	458	338	338	338	218	98	0	0	0
1,775	1,800	202	82	0	0	3,900	3,950	605	596	473	470	467	347	347	347	227	107	0	0	0
1,800	1,825	206	86	0	0	3,950	4,000	615	605	483	479	476	356	356	356	236	116	0	0	0
1,825	1,850	211	91	0	0	4,000	4,050	625	615	493	489	485	365	365	365	245	125	5	0	0
1,850	1,875	215	95	0	0	4,050	4,100	635	624	503	498	494	374	374	374	254	134	14	0	0
1,875	1,900	220	100	0	0	4,100	4,150	645	634	513	508	503	383	383	383	263	143	23	0	0
1,900	1,925	224	104	0	0	4,150	4,200	655	643	523	517	512	392	392	392	272	152	32	0	0
1,925	1,950	229	109	0	0	4,200	4,250	665	653	533	527	521	401	401	401	281	161	41	0	0
1,950	1,975	233	113	0	0	4,250	4,300	674	662	542	536	530	410	410	410	290	170	50	0	0
1,975	2,000	238	118	0	0	4,300	4,350	684	671	552	545	539	420	419	419	299	179	59	0	0
2,000	2,025	242	122	2	0	4,350	4,400	694	681	562	555	548	430	429	428	308	188	68	0	0
2,025	2,050	247	127	7	0	4,400	4,450	704	690	572	564	557	440	438	437	317	197	77	0	0
2,050	2,075	251	131	11	0	4,450	4,500	714	700	582	574	566	450	448	446	326	206	86	0	0
2,075	2,100	256	136	16	0	4,500	4,550	724	709	592	583	575	460	457	455	335	215	95	0	0
2,100	2,125	260	140	20	0	4,550	4,600	734	719	602	593	584	470	467	464	344	224	104	0	0
2,125	2,150	265	145	25	0	4,600	4,650	744	728	612	602	593	480	476	473	353	233	113	0	0
2,150	2,175	269	149	29	0	4,650	4,700	754	738	622	612	602	490	486	482	362	242	122	2	0
2,175	2,200	274	154	34	0	4,700	4,750	764	747	632	621	611	500	495	491	371	251	131	11	0
2,200	2,225	278	158	38	0	4,750	4,800	773	756	641	630	620	509	504	500	380	260	140	20	0
2,225	2,250	283	163	43	0	4,800	4,850	783	766	651	640	629	519	514	509	389	269	149	29	0
2,250	2,275	287	167	47	0	4,850	4,900	793	775	661	649	638	529	523	518	398	278	158	38	0
2,275	2,300	292	172	52	0	4,900	4,950	803	785	671	659	647	539	533	527	407	287	167	47	0
2,300	2,325	296	176	56	0	4,950	5,000	813	794	681	668	656	549	542	536	416	296	176	56	0

§ 3

SEC. 4. RULES FOR OPTIONAL TAX.

(a) NUMBER OF EXEMPTIONS.—For purposes of the table in section 3, the term "number of exemptions" means the number of the exemptions allowed under section 151 as deductions in computing taxable income.

(b) MANNER OF ELECTION.—The election referred to in section 3 shall be made in the manner provided in regulations prescribed by the Secretary or his delegate.

(c) HUSBAND OR WIFE FILING SEPARATE RETURN.—A husband or wife may not elect to pay the optional tax imposed by section 3 if the tax of the other spouse is determined under section 1 on the basis of taxable income computed without regard to the standard deduction. For purposes of the preceding sentence, determination of marital status shall be made under section 143.

(d) CERTAIN OTHER TAXPAYERS INELIGIBLE.—Section 3 shall not apply to—

(1) a nonresident alien individual;

(2) a citizen of the United States entitled to the benefits of section 931 (relating to income from sources within possessions of the United States);

(3) an individual making a return under section 443 (a) (1) for a period of less than 12 months on account of a change in his accounting period; or

(4) an estate or trust.

(e) TAXABLE INCOME COMPUTED WITH STANDARD DEDUCTION.—Whenever it is necessary to determine the taxable income of a taxpayer who made the election referred to in section 3, the taxable income shall be determined under section 63 (b) (relating to definition of taxable income for individuals electing standard deduction).

(f) CROSS REFERENCES.—

(1) For other applicable rules (including rules as to the change of an election under section 3), see section 144.

(2) For disallowance of certain credits against tax, see section 36.

SEC. 5. CROSS REFERENCES RELATING TO TAX ON INDIVIDUALS.

(a) OTHER RATES OF TAX ON INDIVIDUALS, ETC.—

(1) For rates of tax on nonresident aliens, see section 871.

(2) For doubling of tax on citizens of certain foreign countries, see section 891.

(3) For alternative tax in case of capital gain, see section 1201 (b).

(4) For rate of withholding in the case of nonresident aliens, see section 1441.

(b) SPECIAL LIMITATIONS ON TAX.—

(1) For limitation on tax attributable to receipt of lump sum under annuity, endowment, or life insurance contract, see section 72 (e) (3).

(2) For limitation on surtax attributable to sales of oil or gas properties, see section 632.

(3) For limitation on tax in case of income of members of Armed Forces on death, see section 692.

(4) For limitation on tax with respect to compensation for long-term services, see section 1301.

(5) For limitation on tax with respect to income from artistic work or inventions, see section 1302.

(6) For limitation on tax in case of back pay, see section 1303.

(7) For computation of tax where taxpayer restores substantial amount held under claim of right, see section 1341.

(8) For limitation on surtax attributable to claims against the United States involving acquisitions of property, see section 1347.

PART II—TAX ON CORPORATIONS

Sec. 11. Tax imposed.
Sec. 12. Cross references relating to tax on corporations.

SEC. 11. TAX IMPOSED.

(a) CORPORATIONS IN GENERAL.—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 subsection (b) and a surtax computed under subsection (c).

(b) NORMAL TAX.—

(1) TAXABLE YEARS BEGINNING BEFORE APRIL 1, 1955.—In the case of a taxable year beginning before April 1, 1955, the normal tax is equal to 30 percent of the taxable income.

(2) TAXABLE YEARS BEGINNING AFTER MARCH 31, 1955.—In the case of a taxable year beginning after March 31, 1955, the normal tax is equal to 25 percent of the taxable income.

(c) SURTAX.—The surtax is equal to 22 percent of the amount by which the taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest) exceeds $25,000.

(d) EXCEPTIONS.—Subsection (a) shall not apply to a corporation subject to a tax imposed by—

(1) section 594 (relating to mutual savings banks conducting life insurance business),

(2) subchapter L (sec. 801 and following, relating to insurance companies),

(3) subchapter M (sec. 851 and following, relating to regulated investment companies), or

(4) section 881 (a) (relating to foreign corporations not engaged in business in United States).

SEC. 12. CROSS REFERENCES RELATING TO TAX ON CORPORATIONS.

(1) For tax on the unrelated business income of certain charitable and other corporations exempt from tax under this chapter, see section 511.

(2) For accumulated earnings tax and personal holding company tax, see parts I and II of subchapter G (sec. 531 and following).

(3) For doubling of tax on corporations of certain foreign countries, see section 891.

(4) For alternative tax in case of capital gains, see section 1201 (a).

(5) For rate of withholding in case of foreign corporations, see section 1442.

(6) For withholding of tax on tax-free covenant bonds, see section 1451.

(7) For limitation on the $25,000 exemption from surtax provided in section 11 (c), see section 1551.

(8) For additional tax for corporations filing consolidated returns, see section 1503.

PART III—CHANGES IN RATES DURING A TAXABLE YEAR

Sec. 21. Effect of changes.

SEC. 21. EFFECT OF CHANGES.

(a) GENERAL RULE.—If any rate of tax imposed by this chapter changes, and if the taxable year includes the effective date of the change (unless that date is the first day of the taxable year), then—

(1) tentative taxes shall be computed by applying the rate for the period before the effective date of the change, and the rate for the period on and after such date, to the taxable income for the entire taxable year; and

(2) the tax for such taxable year shall be the sum of that proportion of each tentative tax which the number of days in each period bears to the number of days in the entire taxable year.

(b) REPEAL OF TAX.—For purposes of subsection (a)—

(1) if a tax is repealed, the repeal shall be considered a change of rate; and

(2) the rate for the period after the repeal shall be zero.

(c) EFFECTIVE DATE OF CHANGE.—For purposes of subsections (a) and (b)—

(1) if the rate changes for taxable years "beginning after" or "ending after" a certain date, the following day shall be considered the effective date of the change; and

(2) if a rate changes for taxable years "beginning on or after" a certain date, that date shall be considered the effective date of the change.

(d) TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1954, AND ENDING AFTER DECEMBER 31, 1953.—In the case of a taxable year beginning before January 1, 1954, and ending after December 31, 1953—

(1) subsection (a) of this section does not apply; and

(2) in the application of subsection (j) of section 108 of the Internal Revenue Code of 1939, the provisions of such code referred to in such subsection shall be considered as continuing in effect as if this subtitle had not been enacted.

PART IV—CREDITS AGAINST TAX

Sec. 31. Tax withheld on wages.
Sec. 32. Tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds.
Sec. 33. Taxes of foreign countries and possessions of the United States.
Sec. 34. Dividends received by individuals.
Sec. 35. Partially tax-exempt interest received by individuals.
Sec. 36. Credits not allowed to individuals paying optional tax or taking standard deduction.
Sec. 37. Retirement income.
Sec. 38. Overpayments of tax.

SEC. 31. TAX WITHHELD ON WAGES.

(a) WAGE WITHHOLDING FOR INCOME TAX PURPOSES.—

(1) IN GENERAL.—The amount withheld under section 3402 as tax on the wages of any individual shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle.

(2) YEAR OF CREDIT.—The amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

(b) CREDIT FOR SPECIAL REFUNDS OF SOCIAL SECURITY TAX.—

(1) IN GENERAL.—The Secretary or his delegate may prescribe regulations providing for the crediting against the tax imposed by this subtitle of the amount determined by the taxpayer or the Secretary (or his delegate) to be allowable under section 6413 (c) as a special refund of tax imposed on wages. The amount allowed as a credit under such regulations shall, for purposes of this subtitle, be considered an amount withheld at source as tax under section 3402.

(2) YEAR OF CREDIT.—Any amount to which paragraph (1) applies shall be allowed as a credit for the taxable year beginning in the calendar year during which the wages were received. If more than one taxable year begins in the calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

SEC. 32. TAX WITHHELD AT SOURCE ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS AND ON TAX-FREE COVENANT BONDS.

There shall be allowed as credits against the tax imposed by this chapter—

(1) the amount of tax withheld at source under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and on foreign corporations), and

(2) the amount of tax withheld at source under subchapter B of chapter 3 (relating to interest on tax-free covenant bonds).

SEC. 33. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF THE UNITED STATES.

The amount of taxes imposed by foreign countries and possessions of the United States shall be allowed as a credit against the tax imposed by this chapter to the extent provided in section 901.

SEC. 34. DIVIDENDS RECEIVED BY INDIVIDUALS.

(a) GENERAL RULE.—Effective with respect to taxable years ending after July 31, 1954, there shall be allowed to an individual, as a credit against the tax imposed by this subtitle for the taxable year, an amount equal to 4 percent of the dividends which are received after July 31, 1954, from domestic corporations and are included in gross income.

(b) LIMITATION ON AMOUNT OF CREDIT.—The credit allowed by subsection (a) shall not exceed whichever of the following is the lesser:

(1) the amount of the tax imposed by this chapter for the taxable year, reduced by the credit allowable under section 33 (relating to foreign tax credit); or

(2) the following percent of the taxable income for the taxable year:

(A) 2 percent, in the case of a taxable year ending before January 1, 1955.

(B) 4 percent, in the case of a taxable year ending after December 31, 1954.

(c) NO CREDIT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—Subsection (a) shall not apply to any dividend from—

(1) an insurance company subject to a tax imposed by part I or II of subchapter L (sec. 801 and following);

(2) a corporation organized under the China Trade Act, 1922 (see sec. 941); or

(3) a corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is—

(A) a corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or

(B) a corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

(d) SPECIAL RULES FOR CERTAIN DISTRIBUTIONS.—For purposes of subsection (a)—

(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

(2) A dividend received from a regulated investment company shall be subject to the limitations prescribed in section 854.

(e) CERTAIN NONRESIDENT ALIENS INELIGIBLE FOR CREDIT.—No credit shall be allowed under subsection (a) to a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section 871 (a).

(f) CROSS REFERENCES.—

(1) For exclusion of certain dividends from gross income, see section 116.

(2) For special rules relating to the credit provided by subsection (a), see sections 642 (trusts and estates), 702 (partnerships), and 584 (common trust funds).

(3) For disallowance of credit where tax is computed by Secretary or his delegate, see section 6014.

SEC. 35. PARTIALLY TAX-EXEMPT INTEREST RECEIVED BY INDIVIDUALS.

(a) IN GENERAL.—There shall be allowed to an individual, as a credit against the tax imposed by this subtitle for the taxable year, an amount equal to 3 percent of the amount received as interest on obligations of the United States or on obligations of corporations organized under Act of Congress which are instrumentalities of the United States, but only if—

(1) such interest is included in gross income; and

(2) such interest is exempt from normal tax under the Act authorizing the issuance of such obligations.

(b) LIMITATION ON AMOUNT OF CREDIT.—The credit allowed by subsection (a) shall not exceed whichever of the following is the lesser:

(1) the amount of the tax imposed by this chapter for the taxable year, reduced by the sum of the credits allowable under sections 33 and 34; or

(2) 3 percent of the taxable income for the taxable year.

(c) CROSS REFERENCE.—

For reduction of credit under this section on account of amortizable bond premium, see section 171.

SEC. 36. CREDITS NOT ALLOWED TO INDIVIDUALS PAYING OPTIONAL TAX OR TAKING STANDARD DEDUCTION.

If an individual elects to pay the optional tax imposed by section 3, or if he elects under section 144 to take the standard deduction, the credits provided by sections 32, 33, and 35 shall not be allowed.

SEC. 37. RETIREMENT INCOME.

(a) GENERAL RULE.—In the case of an individual who has received earned income before the beginning of the taxable year, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the amount received by such individual as retirement income (as defined in subsection (c) and as limited by subsection (d)), multiplied by the rate provided in section 1 for the first $2,000 of taxable income; but this credit shall not exceed such tax reduced by the credits allowable under section 32 (2) (relating to tax withheld at source on tax-free covenant bonds), section 33 (relating to foreign tax credit), section 34 (relating to credit for dividends received by individuals), and section 35 (relating to partially tax exempt interest).

(b) INDIVIDUAL WHO HAS RECEIVED EARNED INCOME.—For purposes of subsection (a), an individual shall be considered to have received earned income if he has received, in each of any 10 calendar years before the taxable year, earned income (as defined in subsection (g)) in excess of $600. A widow or widower whose spouse had received such earned income shall be considered to have received earned income.

(c) RETIREMENT INCOME.—For purposes of subsection (a), the term "retirement income" means—

(1) in the case of an individual who has attained the age of 65 before the close of the taxable year, income from—

(A) pensions and annuities,

(B) interest,

(C) rents, and

(D) dividends, or

(2) in the case of an individual who has not attained the age of 65 before the close of the taxable year, income from pensions and annuities under a public retirement system (as defined in subsection (f)),

to the extent included in gross income without reference to this section, but only to the extent such income does not represent compensation for personal services rendered during the taxable year.

(d) LIMITATION ON RETIREMENT INCOME.—For purposes of subsection (a), the amount of retirement income shall not exceed $1,200 less—

(1) in the case of any individual, any amount received by the individual as a pension or annuity—

(A) under title II of the Social Security Act,

(B) under the Railroad Retirement Acts of 1935 or 1937, or

(C) otherwise excluded from gross income, and

(2) in the case of any individual who has not attained the age of 75 before the close of the taxable year, any amount of earned income (as defined in subsection (g)) in excess of $900 received by the individual in the taxable year.

(e) RULE FOR APPLICATION OF SUBSECTION (d) (1).—Subsection (d) (1) shall not apply to any amount excluded from gross income under section 72 (relating to annuities), 101 (relating to life insurance proceeds), 104 (relating to compensation for injuries or sickness), 105 (relating to amounts received under accident and health plans), 402 (relating to taxability of beneficiary of employees' trust), or 403 (relating to taxation of employee annuities).

(f) PUBLIC RETIREMENT SYSTEM DEFINED.—For purposes of subsection (c) (2), the term "public retirement system" means a pension, annuity, retirement, or similar fund or system established by the United States, a State, a Territory, a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia; except that such term does not include a fund or system established by the United States for members of the Armed Forces of the United States.

(g) EARNED INCOME DEFINED.—For purposes of subsections (b) and (d) (2), the term "earned income" has the meaning assigned to such term in section 911 (b), except that such term does not include any amount received as a pension or annuity.

(h) NONRESIDENT ALIEN INELIGIBLE FOR CREDIT.—No credit shall be allowed under subsection (a) to any nonresident alien.

(i) CROSS REFERENCE.—

For disallowance of credit where tax is computed by Secretary or his delegate, see section 6014 (a).

SEC. 38. OVERPAYMENTS OF TAX.

For credit against the tax imposed by this subtitle for overpayments of tax, see section 6401.

Subchapter B—Computation of Taxable Income

Part I. Definition of gross income, adjusted gross income, and taxable income.
Part II. Items specifically included in gross income.
Part III. Items specifically excluded from gross income.
Part IV. Standard deduction for individuals.
Part V. Deductions for personal exemptions.
Part VI. Itemized deductions for individuals and corporations.
Part VII. Additional itemized deductions for individuals.
Part VIII. Special deductions for corporations.
Part IX. Items not deductible.

PART I—DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, AND TAXABLE INCOME

Sec. 61. Gross income defined.
Sec. 62. Adjusted gross income defined.
Sec. 63. Taxable income defined.

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

(b) Cross References.—

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

SEC. 62. ADJUSTED GROSS INCOME DEFINED.

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions.—The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer,

if such trade or business does not consist of the performance of services by the taxpayer as an employee.

(2) TRADE AND BUSINESS DEDUCTIONS OF EMPLOYEES.—

(A) REIMBURSED EXPENSES.—The deductions allowed by part VI (sec. 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer.

(B) EXPENSES FOR TRAVEL AWAY FROM HOME.—The deductions allowed by part VI (sec. 161 and following) which consist of expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee.

(C) TRANSPORTATION EXPENSES.—The deductions allowed by part VI (sec. 161 and following) which consist of expenses of transportation paid or incurred by the taxpayer in connection with the performance by him of services as an employee.

(D) OUTSIDE SALESMEN.—The deductions allowed by part VI (sec. 161 and following) which are attributable to a trade or business carried on by the taxpayer, if such trade or business consists of the performance of services by the taxpayer as an employee and if such trade or business is to solicit, away from the employer's place of business, business for the employer.

(3) LONG-TERM CAPITAL GAINS.—The deduction allowed by section 1202.

(4) LOSSES FROM SALE OR EXCHANGE OF PROPERTY.—The deductions allowed by part VI (sec. 161 and following) as losses from the sale or exchange of property.

(5) DEDUCTIONS ATTRIBUTABLE TO RENTS AND ROYALTIES.—The deductions allowed by part VI (sec. 161 and following), by section 212 (relating to expenses for production of income), and by section 611 (relating to depletion) which are attributable to property held for the production of rents or royalties.

(6) CERTAIN DEDUCTIONS OF LIFE TENANTS AND INCOME BENEFICIARIES OF PROPERTY.—In the case of a life tenant of property, or an income beneficiary of property held in trust, or an heir, legatee, or devisee of an estate, the deduction for depreciation allowed by section 167 and the deduction allowed by section 611.

Nothing in this section shall permit the same item to be deducted more than once.

SEC. 63. TAXABLE INCOME DEFINED.

(a) GENERAL RULE.—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

(b) INDIVIDUALS ELECTING STANDARD DEDUCTION.—In the case of an individual electing under section 144 to use the standard deduction provided in part IV (sec. 141 and following), for purposes of this subtitle the term "taxable income" means adjusted gross income, minus—

(1) such standard deduction, and

(2) the deductions for personal exemptions provided in section 151.

PART II—ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

Sec. 71. Alimony and separate maintenance payments.
Sec. 72. Annuities; certain proceeds of endowment and life insurance contracts.
Sec. 73. Services of child.
Sec. 74. Prizes and awards.
Sec. 75. Dealers in tax-exempt securities.
Sec. 76. Mortgages made or obligations issued by joint-stock land banks.
Sec. 77. Commodity credit loans.

SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

(a) General Rule.—

(1) Decree of divorce or separate maintenance.—If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

(2) Written separation agreement.—If a wife is separated from her husband and there is a written separation agreement executed after the date of the enactment of this title, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such agreement is executed which are made under such agreement and because of the marital or family relationship (or which are attributable to property transferred, in trust or otherwise, under such agreement and because of such relationship). This paragraph shall not apply if the husband and wife make a single return jointly.

(3) Decree for support.—If a wife is separated from her husband, the wife's gross income includes periodic payments (whether or not made at regular intervals) received by her after the date of the enactment of this title from her husband under a decree entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. This paragraph shall not apply if the husband and wife make a single return jointly.

(b) Payments to Support Minor Children.—Subsection (a) shall not apply to that part of any payment which the terms of the decree, instrument, or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband. For purposes of the preceding sentence, if any payment is less than the amount specified in the decree, instrument, or agreement, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

(c) Principal Sum Paid in Installments.—

(1) General rule.—For purposes of subsection (a), installment payments discharging a part of an obligation the principal sum of which is, either in terms of money or property, specified in the

decree, instrument, or agreement shall not be treated as periodic payments.

(2) WHERE PERIOD FOR PAYMENT IS MORE THAN 10 YEARS.—If, by the terms of the decree, instrument, or agreement, the principal sum referred to in paragraph (1) is to be paid or may be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement, then (notwithstanding paragraph (1)) the installment payments shall be treated as periodic payments for purposes of subsection (a), but (in the case of any one taxable year of the wife) only to the extent of 10 percent of the principal sum. For purposes of the preceding sentence, the part of any principal sum which is allocable to a period after the taxable year of the wife in which it is received shall be treated as an installment payment for the taxable year in which it is received.

(d) RULE FOR HUSBAND IN CASE OF TRANSFERRED PROPERTY.—The husband's gross income does not include amounts received which, under subsection (a), are (1) includible in the gross income of the wife, and (2) attributable to transferred property.

(e) CROSS REFERENCES.—

(1) For definitions of "husband" and "wife", see section 7701 (a) (17).

(2) For deduction by husband of periodic payments not attributable to transferred property, see section 215.

(3) For taxable status of income of an estate or trust in case of divorce, etc., see section 682.

SEC. 72. ANNUITIES; CERTAIN PROCEEDS OF ENDOWMENT AND LIFE INSURANCE CONTRACTS.

(a) GENERAL RULE FOR ANNUITIES.—Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

(b) EXCLUSION RATIO.—Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date). This subsection shall not apply to any amount to which subsection (d) (1) (relating to certain employee annuities) applies.

(c) DEFINITIONS.—

(1) INVESTMENT IN THE CONTRACT.—For purposes of subsection (b), the investment in the contract as of the annuity starting date is—

(A) the aggregate amount of premiums or other consideration paid for the contract, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

(2) ADJUSTMENT IN INVESTMENT WHERE THERE IS REFUND FEATURE.—If—

(A) the expected return under the contract depends in whole or in part on the life expectancy of one or more individuals;

(B) the contract provides for payments to be made to a beneficiary (or to the estate of an annuitant) on or after the death of the annuitant or annuitants; and

(C) such payments are in the nature of a refund of the consideration paid,

then the value (computed without discount for interest) of such payments on the annuity starting date shall be subtracted from the amount determined under paragraph (1). Such value shall be computed in accordance with actuarial tables prescribed by the Secretary or his delegate. For purposes of this paragraph and of subsection (e) (2) (A), the term "refund of the consideration paid" includes amounts payable after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain, but (if part of the consideration was contributed by an employer) does not include that part of any payment to a beneficiary (or to the estate of the annuitant) which is not attributable to the consideration paid by the employee for the contract as determined under paragraph (1) (A).

(3) EXPECTED RETURN.—For purposes of subsection (b), the expected return under the contract shall be determined as follows:

(A) LIFE EXPECTANCY.—If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary or his delegate.

(B) INSTALLMENT PAYMENTS.—If subparagraph (A) does not apply, the expected return is the aggregate of the amounts receivable under the contract as an annuity.

(4) ANNUITY STARTING DATE.—For purposes of this section, the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract; except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.

(d) EMPLOYEES' ANNUITIES.—

(1) EMPLOYEE'S CONTRIBUTIONS RECOVERABLE IN 3 YEARS.—Where—

(A) part of the consideration for an annuity, endowment, or life insurance contract is contributed by the employer, and

(B) during the 3-year period beginning on the date (whether or not before January 1, 1954) on which an amount is first received under the contract as an annuity, the aggregate amount receivable by the employee under the terms of the contract is equal to or greater than the consideration for the contract contributed by the employee,

then all amounts received as an annuity under the contract shall be excluded from gross income until there has been so excluded (under this paragraph and prior income tax laws) an amount equal to the consideration for the contract contributed by the employee. Thereafter all amounts so received under the contract shall be included in gross income.

(2) SPECIAL RULES FOR APPLICATION OF PARAGRAPH (1).—For purposes of paragraph (1), if the employee died before any amount was received as an annuity under the contract, the words "receivable by the employee" shall be read as "receivable by a beneficiary of the employee".

(3) CROSS REFERENCE.—

For certain rules for determining whether amounts contributed by employer are includible in the gross income of the employee, see part I of subchapter D (sec. 401 and following, relating to pension, profit-sharing, and stock bonus plans, etc.).

(e) AMOUNTS NOT RECEIVED AS ANNUITIES.—

(1) GENERAL RULE.—If any amount is received under an annuity, endowment, or life insurance contract, if such amount is not received as an annuity, and if no other provision of this subtitle applies, then such amount—

(A) if received on or after the annuity starting date, shall be included in gross income; or

(B) if subparagraph (A) does not apply, shall be included in gross income, but only to the extent that it (when added to amounts previously received under the contract which were excludable from gross income under this subtitle or prior income tax laws) exceeds the aggregate premiums or other consideration paid.

For purposes of this section, any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

(2) SPECIAL RULES FOR APPLICATION OF PARAGRAPH (1).—For purposes of paragraph (1), the following shall be treated as amounts not received as an annuity:

(A) any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract; and

(B) any amount received under a contract on its surrender, redemption, or maturity.

In the case of any amount to which the preceding sentence applies, the rule of paragraph (1) (B) shall apply (and the rule of paragraph (1) (A) shall not apply).

(3) LIMIT ON TAX ATTRIBUTABLE TO RECEIPT OF LUMP SUM.—If a lump sum is received under an annuity, endowment, or life insurance contract, and the part which is includible in gross income is determined under paragraph (1), then the tax attributable to the inclusion of such part in gross income for the taxable year shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of the taxpayer ratably over the taxable year in which received and the preceding 2 taxable years.

(f) SPECIAL RULES FOR COMPUTING EMPLOYEES' CONTRIBUTIONS.—In computing, for purposes of subsection (c) (1) (A), the aggregate amount of premiums or other consideration paid for the contract, for purposes of subsection (d) (1), the consideration for the contract contributed by the employee, and for purposes of subsection (e) (1) (B), the aggregate premiums or other consideration paid, amounts contributed by the employer shall be included, but only to the extent that—

(1) such amounts were includible in the gross income of the employee under this subtitle or prior income tax laws; or

(2) if such amounts had been paid directly to the employee at the time they were contributed, they would not have been includible in the gross income of the employee under the law applicable at the time of such contribution.

(g) RULES FOR TRANSFEREE WHERE TRANSFER WAS FOR VALUE.—Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable consideration, to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then—

(1) for purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;

(2) for purposes of subsection (c) (1) (B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(3) the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.

For purposes of this subsection, the term "transferee" includes a beneficiary of, or the estate of, the transferee.

(h) OPTION TO RECEIVE ANNUITY IN LIEU OF LUMP SUM.—If—

(1) a contract provides for payment of a lump sum in full discharge of an obligation under the contract, subject to an option to receive an annuity in lieu of such lump sum;

(2) the option is exercised within 60 days after the day on which such lump sum first became payable; and

(3) part or all of such lump sum would (but for this subsection) be includible in gross income by reason of subsection (e) (1),

then, for purposes of this subtitle, no part of such lump sum shall be considered as includible in gross income at the time such lump sum first became payable.

(i) JOINT AND SURVIVOR ANNUITIES WHERE FIRST ANNUITANT DIED IN 1951, 1952, OR 1953.—Where an annuitant died after December 31, 1950, and before January 1, 1954, and the basis of a surviving annuitant's interest in the joint and survivor annuity contract was determinable under section 113 (a) (5) of the Internal Revenue Code of 1939, then—

(1) subsection (d) shall not apply with respect to such contract;

(2) for purposes of this section, the aggregate amount of premiums or other consideration paid for the contract is the basis of the contract determined under such section 113 (a) (5);

(3) for purposes of subsection (c) (1) (B), there shall be taken into account only the aggregate amount received by the surviving annuitant under the contract before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(4) the annuity starting date is January 1, 1954, or the first day of the first period for which the surviving annuitant received an amount under the contract as an annuity, whichever is the later.

(j) INTEREST.—Notwithstanding any other provision of this section, if any amount is held under an agreement to pay interest thereon, the interest payments shall be included in gross income.

(k) PAYMENTS IN DISCHARGE OF ALIMONY.—

(1) IN GENERAL.—This section shall not apply to so much of any payment under an annuity, endowment, or life insurance contract (or any interest therein) as is includible in the gross income of the wife under section 71 or section 682 (relating to income of an estate or trust in case of divorce, etc.).

(2) CROSS REFERENCE.—

For definition of "wife", see section 7701 (a) (17).

(l) FACE-AMOUNT CERTIFICATES.—For purposes of this section, the term "endowment contract" includes a face-amount certificate, as defined in section 2 (a) (15) of the Investment Company Act of 1940 (15 U. S. C., sec. 80a–2), issued after December 31, 1954.

(m) CROSS REFERENCE.—

For limitation on adjustments to basis of annuity contracts sold, see section 1021.

SEC. 73. SERVICES OF CHILD.

(a) TREATMENT OF AMOUNTS RECEIVED.—Amounts received in respect of the services of a child shall be included in his gross income and not in the gross income of the parent, even though such amounts are not received by the child.

(b) TREATMENT OF EXPENDITURES.—All expenditures by the parent or the child attributable to amounts which are includible in the gross income of the child (and not of the parent) solely by reason of subsection (a) shall be treated as paid or incurred by the child.

(c) PARENT DEFINED.—For purposes of this section, the term "parent" includes an individual who is entitled to the services of a child by reason of having parental rights and duties in respect of the child.

(d) CROSS REFERENCE.—

For assessment of tax against parent in certain cases, see section 6201 (c).

SEC. 74. PRIZES AND AWARDS.

(a) GENERAL RULE.—Except as provided in subsection (b) and in section 117 (relating to scholarships and fellowship grants), gross income includes amounts received as prizes and awards.

(b) EXCEPTION.—Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if—

(1) the recipient was selected without any action on his part to enter the contest or proceeding; and

(2) the recipient is not required to render substantial future services as a condition to receiving the prize or award.

SEC. 75. DEALERS IN TAX-EXEMPT SECURITIES.

(a) ADJUSTMENT FOR BOND PREMIUM.—In computing the gross income of a taxpayer who holds during the taxable year a short-term municipal bond (as defined in subsection (b) (1)) primarily for sale to customers in the ordinary course of his trade or business—

(1) if the gross income of the taxpayer from such trade or business is computed by the use of inventories and his inventories are valued on any basis other than cost, the cost of securities sold (as defined in subsection (b) (2)) during such year shall be reduced by an amount equal to the amortizable bond premium which would be disallowed as a deduction for such year by section 171 (a) (2) (relating to deduction for amortizable bond premium) if the definition in section 171 (d) of the term "bond" did not exclude such short-term municipal bond; or

(2) if the gross income of the taxpayer from such trade or business is computed without the use of inventories, or by use of inventories valued at cost, and the short-term municipal bond is sold or otherwise disposed of during such year, the adjusted basis (computed without regard to this paragraph) of the short-term municipal bond shall be reduced by the amount of the adjustment which would be required under section 1016 (a) (5) (relating to adjustment to basis for amortizable bond premium) if the definition in section 171 (d) of the term "bond" did not exclude such short-term municipal bond.

(b) DEFINITIONS.—For purposes of subsection (a)—

(1) The term "short-term municipal bond" means any obligation issued by a government or political subdivision thereof if the interest on such obligation is excludable from gross income; but such term does not include such an obligation if—

(A) it is sold or otherwise disposed of by the taxpayer within 30 days after the date of its acquisition by him, or

(B) its earliest maturity or call date is a date more than 5 years from the date on which it was acquired by the taxpayer.

(2) The term "cost of securities sold" means the amount ascertained by subtracting the inventory value of the closing inventory of a taxable year from the sum of—

(A) the inventory value of the opening inventory for such year, and

(B) the cost of securities and other property purchased during such year which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

SEC. 76. MORTGAGES MADE OR OBLIGATIONS ISSUED BY JOINT-STOCK LAND BANKS.

All income (except interest) derived from mortgages made, or obligations issued, after May 28, 1938, by a joint-stock land bank shall (notwithstanding section 26 of the Federal Farm Loan Act; 12 U. S. C. 931–3) be included in gross income.

SEC. 77. COMMODITY CREDIT LOANS.

(a) ELECTION TO INCLUDE LOANS IN INCOME.—Amounts received as loans from the Commodity Credit Corporation shall, at the election of the taxpayer, be considered as income and shall be included in gross income for the taxable year in which received.

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(b) EFFECT OF ELECTION ON ADJUSTMENTS FOR SUBSEQUENT YEARS.—If a taxpayer exercises the election provided for in subsection (a) for any taxable year, then the method of computing income so adopted shall be adhered to with respect to all subsequent taxable years unless with the approval of the Secretary or his delegate a change to a different method is authorized.

PART III—ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

Sec. 101. Certain death payments.
Sec. 102. Gifts and inheritances.
Sec. 103. Interest on certain governmental obligations.
Sec. 104. Compensation for injuries or sickness.
Sec. 105. Amounts received under accident and health plans.
Sec. 106. Contributions by employer to accident and health plans.
Sec. 107. Rental value of parsonages.
Sec. 108. Income from discharge of indebtedness.
Sec. 109. Improvements by lessee on lessor's property.
Sec. 110. Income taxes paid by lessee corporation.
Sec. 111. Recovery of bad debts, prior taxes, and delinquency amounts.
Sec. 112. Certain combat pay of members of the Armed Forces.
Sec. 113. Mustering-out payments for members of the Armed Forces.
Sec. 114. Sports programs conducted for the American National Red Cross.
Sec. 115. Income of States, municipalities, etc.
Sec. 116. Partial exclusion of dividends received by individuals.
Sec. 117. Scholarships and fellowship grants.
Sec. 118. Contributions to the capital of a corporation.
Sec. 119. Meals or lodging furnished for convenience of employer.
Sec. 120. Statutory subsistence allowance received by police.
Sec. 121. Cross references to other Acts.

SEC. 101. CERTAIN DEATH BENEFITS.

(a) PROCEEDS OF LIFE INSURANCE CONTRACTS PAYABLE BY REASON OF DEATH.—

(1) GENERAL RULE.—Except as otherwise provided in paragraph (2) and in subsection (d), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.

(2) TRANSFER FOR VALUABLE CONSIDERATION.—In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee. The preceding sentence shall not apply in the case of such a transfer—

(A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or

(B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

(b) EMPLOYEES' DEATH BENEFITS.—

(1) GENERAL RULE.—Gross income does not include amounts received (whether in a single sum or otherwise) by the beneficiaries or the estate of an employee, if such amounts are paid by or on behalf of an employer and are paid by reason of the death of the employee.

(2) SPECIAL RULES FOR PARAGRAPH (1).—

(A) $5,000 LIMITATION.—The aggregate amounts excludable under paragraph (1) with respect to the death of any employee shall not exceed $5,000.

(B) NONFORFEITABLE RIGHTS.—Paragraph (1) shall not apply to amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (other than total distributions payable, as defined in section 402 (a) (3), which are paid to a distributee, by a stock bonus, pension, or profit-sharing trust described in section 401 (a) which is exempt from tax under section 501 (a), or under an annuity contract under a plan which meets the requirements of paragraphs (3), (4), (5), and (6) of section 401 (a), within one taxable year of the distributee by reason of the employee's death).

(C) JOINT AND SURVIVOR ANNUITIES.—Paragraph (1) shall not apply to amounts received by a surviving annuitant under a joint and survivor's annuity contract after the first day of the first period for which an amount was received as an annuity by the employee (or would have been received if the employee had lived).

(D) OTHER ANNUITIES.—In the case of any amount to which section 72 (relating to annuities, etc.) applies, the amount which is excludable under paragraph (1) (as modified by the preceding subparagraphs of this paragraph) shall be determined by reference to the value of such amount as of the day on which the employee died. Any amount so excludable under paragraph (1) shall, for purposes of section 72, be treated as additional consideration paid by the employee.

(c) INTEREST.—If any amount excluded from gross income by subsection (a) or (b) is held under an agreement to pay interest thereon, the interest payments shall be included in gross income.

(d) PAYMENT OF LIFE INSURANCE PROCEEDS AT A DATE LATER THAN DEATH.—

(1) GENERAL RULE.—The amounts held by an insurer with respect to any beneficiary shall be prorated (in accordance with such regulations as may be prescribed by the Secretary or his delegate) over the period or periods with respect to which such payments are to be made. There shall be excluded from the gross income of such beneficiary in the taxable year received—

(A) any amount determined by such proration, and

(B) in the case of the surviving spouse of the insured, that portion of the excess of the amounts received under one or more agreements specified in paragraph (2) (A) (whether or not payment of any part of such amounts is guaranteed by the insurer) over the amount determined in subparagraph (A) of this para-

graph which is not greater than $1,000 with respect to any insured.

Gross income includes, to the extent not excluded by the preceding sentence, amounts received under agreements to which this subsection applies.

(2) AMOUNT HELD BY AN INSURER.—An amount held by an insurer with respect to any beneficiary shall mean an amount to which subsection (a) applies which is—

(A) held by any insurer under an agreement provided for in the life insurance contract, whether as an option or otherwise, to pay such amount on a date or dates later than the death of the insured, and

(B) is equal to the value of such agreement to such beneficiary

(i) as of the date of death of the insured (as if any option exercised under the life insurance contract were exercised at such time), and

(ii) as discounted on the basis of the interest rate and mortality tables used by the insurer in calculating payments under the agreement.

(3) SURVIVING SPOUSE.—For purposes of this subsection, the term "surviving spouse" means the spouse of the insured as of the date of death, including a spouse legally separated but not under a decree of absolute divorce.

(4) APPLICATION OF SUBSECTION.—This subsection shall not apply to any amount to which subsection (c) is applicable.

(e) ALIMONY, ETC., PAYMENTS.—

(1) IN GENERAL.—This section shall not apply to so much of any payment as is includible in the gross income of the wife under section 71 (relating to alimony) or section 682 (relating to income of an estate or trust in case of divorce, etc.).

(2) CROSS REFERENCE.—

For definition of "wife", see section 7701 (a) (17).

(f) EFFECTIVE DATE OF SECTION.—This section shall apply only to amounts received by reason of the death of an insured or an employee occurring after the date of enactment of this title. Section 22 (b) (1) of the Internal Revenue Code of 1939 shall apply to amounts received by reason of the death of an insured or an employee occurring on or before such date.

SEC. 102. GIFTS AND INHERITANCES.

(a) GENERAL RULE.—Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

(b) INCOME.—Subsection (a) shall not exclude from gross income—

(1) the income from any property referred to in subsection (a); or

(2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

Where, under the terms of the gift, bequest, devise, or inheritance, the payment, crediting, or distribution thereof is to be made at intervals, then, to the extent that it is paid or credited or to be distributed out of income from property, it shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property. Any amount included in the gross income of a

beneficiary under subchapter J shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property.

SEC. 103. INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS.

(a) GENERAL RULE.—Gross income does not include interest on—

(1) 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;

(2) the obligations of the United States; or

(3) the obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States and if under the respective Acts authorizing the issue of the obligations the interest is wholly exempt from the taxes imposed by this subtitle.

(b) EXCEPTION.—Subsection (a) (2) shall not apply to interest on obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit, to the extent they represent deposits made before March 1, 1941), unless under the respective Acts authorizing the issuance thereof such interest is wholly exempt from the taxes imposed by this subtitle.

(c) CROSS REFERENCES.—

For provisions relating to the taxable status of—

(1) Bonds and certificates of indebtedness authorized by the First Liberty Bond Act, see sections 1 and 6 of that Act (40 Stat. 35, 36; 31 U. S. C. 746, 755);

(2) Bonds issued to restore or maintain the gold reserve, see section 2 of the Act of March 14, 1900 (31 Stat. 46; 31 U. S. C. 408);

(3) Bonds, notes, certificates of indebtedness, and Treasury bills authorized by the Second Liberty Bond Act, see sections 4, 5 (b) and (d), 7, 18 (b), and 22 (d) of that Act, as amended (40 Stat. 290; 46 Stat. 20, 775; 40 Stat. 291, 1310; 55 Stat. 8; 31 U. S. C. 752a, 754, 747, 753, 757c);

(4) Bonds, notes, and certificates of indebtedness of the United States and bonds of the War Finance Corporation owned by certain nonresidents, see section 3 of the Fourth Liberty Bond Act, as amended (40 Stat. 1311, § 4; 31 U. S. C. 750);

(5) Certificates of indebtedness issued after February 4, 1910, see section 2 of the Act of that date (36 Stat. 192; 31 U. S. C. 769);

(6) Consols of 1930, see section 11 of the Act of March 14, 1900 (31 Stat. 48; 31 U. S. C. 751);

(7) Obligations and evidences of ownership issued by the United States or any of its agencies or instrumentalities on or after March 28, 1942, see section 4 of the Public Debt Act of 1941, as amended (c. 147, 61 Stat. 180; 31 U. S. C. 742a);

(8) Commodity Credit Corporation obligations, see section 5 of the Act of March 8, 1938 (52 Stat. 108; 15 U. S. C. 713a-5);

(9) Debentures issued by Federal Housing Administrator, see sections 204 (d) and 207 (i) of the National Housing Act, as amended (52 Stat. 14, 20; 12 U. S. C. 1710, 1713);

(10) Debentures issued to mortgagees by United States Maritime Commission, see section 1105 (c) of the Merchant Marine Act, 1936, as amended (52 Stat. 972; 46 U. S. C. 1275);

(11) Federal Deposit Insurance Corporation obligations, see section 15 of the Federal Deposit Insurance Act (64 Stat. 890; 12 U. S. C. 1825);

(12) Federal Home Loan Bank obligations, see section 13 of the Federal Home Loan Bank Act, as amended (49 Stat. 295, § 8; 12 U. S. C. 1433);

(13) Federal savings and loan association loans, see section 5 (h) of the Home Owners' Loan Act of 1933, as amended (48 Stat. 133; 12 U. S. C. 1464);

(14) Federal Savings and Loan Insurance Corporation obligations, see section 402 (e) of the National Housing Act (48 Stat. 1257; 12 U. S. C. 1725);

(15) Home Owners' Loan Corporation bonds, see section 4 (c) of the Home Owners' Loan Act of 1933, as amended (48 Stat. 644, c. 168; 12 U. S. C. 1463);

(16) Obligations of Central Bank for Cooperatives, production credit corporations, production credit associations, and banks for cooperatives, see section 63 of the Farm Credit Act of 1933 (48 Stat. 267; 12 U. S. C. 1138c);

(17) Panama Canal bonds, see section 1 of the Act of December 21, 1904 (34 Stat. 5; 31 U. S. C. 743), section 8 of the Act of June 28, 1902 (32 Stat. 484; 31 U. S. C. 744), and section 39 of the Tariff Act of 1909 (36 Stat. 117; 31 U. S. C. 745);

(18) Philippine bonds, etc., issued before the independence of the Philippines, see section 9 of the Philippine Independence Act (48 Stat. 463; 48 U. S. C. 1239);

(19) Postal savings bonds, see section 10 of the Act of June 25, 1910 (36 Stat. 817; 39 U. S. C. 760);

(20) Puerto Rican bonds, see section 3 of the Act of March 2, 1917, as amended (50 Stat. 844; 48 U. S. C. 745);

(21) Treasury notes issued to retire national bank notes, see section 18 of the Federal Reserve Act (38 Stat. 268; 12 U. S. C. 447);

(22) United States Housing Authority obligations, see sections 5 (e) and 20 (b) of the United States Housing Act of 1937 (50 Stat. 890, 898; 42 U. S. C. 1405, 1420);

(23) Virgin Islands insular and municipal bonds, see section 1 of the Act of October 27, 1949 (63 Stat. 940; 48 U. S. C. 1403).

SEC. 104. COMPENSATION FOR INJURIES OR SICKNESS.

(a) IN GENERAL.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness;

(3) amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer); and

(4) amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service.

(b) CROSS REFERENCES.—

(1) For exclusion from employee's gross income of employer contributions to accident and health plans, see section 106.

(2) For exclusion of part of disability retirement pay from the application of subsection (a) (4) of this section, see section 402 (h) of the Career Compensation Act of 1949 (37 U. S. C. 272 (h)).

SEC. 105. AMOUNTS RECEIVED UNDER ACCIDENT AND HEALTH PLANS.

(a) AMOUNTS ATTRIBUTABLE TO EMPLOYER CONTRIBUTIONS.—Except as otherwise provided in this section, amounts received by an

employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

(b) AMOUNTS EXPENDED FOR MEDICAL CARE.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213 (e)) of the taxpayer, his spouse, and his dependents (as defined in section 152).

(c) PAYMENTS UNRELATED TO ABSENCE FROM WORK.—Gross income does not include amounts referred to in subsection (a) to the extent such amounts—

(1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and

(2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work.

(d) WAGE CONTINUATION PLANS.—Gross income does not include amounts referred to in subsection (a) if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness; but this subsection shall not apply to the extent that such amounts exceed a weekly rate of $100. In the case of a period during which the employee is absent from work on account of sickness, the preceding sentence shall not apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of sickness for at least one day during such period. If such amounts are not paid on the basis of a weekly pay period, the Secretary or his delegate shall by regulations prescribe the method of determining the weekly rate at which such amounts are paid.

(e) ACCIDENT AND HEALTH PLANS.—For purposes of this section and section 104—

(1) amounts received under an accident or health plan for employees, and

(2) amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia,

shall be treated as amounts received through accident or health insurance.

(f) RULES FOR APPLICATION OF SECTION 213.—For purposes of section 213 (a) (relating to medical, dental, etc., expenses) amounts excluded from gross income under subsection (c) or (d) shall not be considered as compensation (by insurance or otherwise) for expenses paid for medical care.

SEC. 106. CONTRIBUTIONS BY EMPLOYER TO ACCIDENT AND HEALTH PLANS.

Gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness.

SEC. 107. RENTAL VALUE OF PARSONAGES.

In the case of a minister of the gospel, gross income does not include—

(1) the rental value of a home furnished to him as part of his compensation; or

(2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.

SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.

(a) SPECIAL RULE OF EXCLUSION.—No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—

(1) the indebtedness was incurred or assumed—

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary or his delegate by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction.

(b) RAILROAD CORPORATIONS.—No amount shall be included in gross income by reason of the discharge, cancellation, or modification, in whole or in part, within the taxable year, of any indebtedness of a railroad corporation, as defined in section 77 (m) of the Bankruptcy Act (11 U. S. C. 205 (m)), if such discharge, cancellation, or modification is effected pursuant to an order of a court in a receivership proceeding or in a proceeding under section 77 of the Bankruptcy Act. In such cases, the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. Subsection (a) of this section shall not apply with respect to any discharge of indebtedness to which this subsection applies. This subsection shall not apply to any discharge occurring in a taxable year beginning after December 31, 1955.

SEC. 109. IMPROVEMENTS BY LESSEE ON LESSOR'S PROPERTY.

Gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

SEC. 110. INCOME TAXES PAID BY LESSEE CORPORATION.

If—

(1) a lease was entered into before January 1, 1954,

(2) both lessee and lessor are corporations, and

(3) under the lease, the lessee is obligated to pay, or to reimburse the lessor for, any part of the tax imposed by this subtitle on the lessor with respect to the rentals derived by the lessor from the lessee,

then gross income of the lessor does not include such payment or reimbursement, and no deduction for such payment or reimbursement shall be allowed to the lessee. For purposes of the preceding sentence, a lease shall be considered to have been entered into before January 1, 1954, if it is a renewal or continuance of a lease entered into before such date and if such renewal or continuance was made in accordance with an option contained in the lease on December 31, 1953.

SEC. 111. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS.

(a) GENERAL RULE.—Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

(b) DEFINITIONS.—For purposes of subsection (a)—

(1) BAD DEBT.—The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) PRIOR TAX.—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) DELINQUENCY AMOUNT.—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(4) RECOVERY EXCLUSION.—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this subtitle (not including the accumulated earnings tax imposed by section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

(c) SPECIAL RULES FOR ACCUMULATED EARNINGS TAX AND FOR PERSONAL HOLDING COMPANY TAX.—In applying subsections (a) and (b) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)—

(1) a recovery exclusion allowed for purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

(2) where a bad debt, prior tax, or delinquency amount was not allowable as a deduction or credit for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then a recovery exclusion shall be allowable if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under section 531 or the tax under section 541.

SEC. 112. CERTAIN COMBAT PAY OF MEMBERS OF THE ARMED FORCES.

(a) ENLISTED PERSONNEL.—Gross income does not include compensation received for active service as a member below the grade of commissioned officer in the Armed Forces of the United States for any month during any part of which such member—

(1) served in a combat zone during an induction period, or

(2) was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone during an induction period; but this paragraph shall not apply for any month during any part of which there are no combatant activities in any combat zone as determined under subsection (c) (3) of this section.

(b) COMMISSIONED OFFICERS.—Gross income does not include so much of the compensation as does not exceed $200 received for active service as a commissioned officer in the Armed Forces of the United States for any month during any part of which such officer—

(1) served in a combat zone during an induction period, or

(2) was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone during an induction period; but this paragraph shall not apply for any month during any part of which there are no combatant activities in any combat zone as determined under subsection (c) (3) of this section.

(c) DEFINITIONS.—For purposes of this section—

(1) The term "commissioned officer" does not include a commissioned warrant officer.

(2) The term "combat zone" means any area which the President of the United States by Executive Order designates, for purposes of this section or corresponding provisions of prior income tax laws, as an area in which Armed Forces of the United States are or have (after June 24, 1950) engaged in combat.

(3) Service is performed in a combat zone only if performed on or after the date designated by the President by Executive Order as the date of the commencing of combatant activities in such zone, and on or before the date designated by the President by Executive Order as the date of the termination of combatant activities in

such zone; except that June 25, 1950, shall be considered the date of the commencing of combatant activities in the combat zone designated in Executive Order 10195.

(4) The term "compensation" does not include pensions and retirement pay.

(5) The term "induction period" means any period during which, under laws heretofore or hereafter enacted relating to the induction of individuals for training and service in the Armed Forces of the United States, individuals (other than individuals liable for induction by reason of a prior deferment) are liable for induction for such training and service.

SEC. 113. MUSTERING-OUT PAYMENTS FOR MEMBERS OF THE ARMED FORCES.

Gross income does not include amounts received during the taxable year as mustering-out payments with respect to service in the Armed Forces of the United States.

SEC. 114. SPORTS PROGRAMS CONDUCTED FOR THE AMERICAN NATIONAL RED CROSS.

(a) GENERAL RULE.—In the case of a taxpayer which is a corporation primarily engaged in the furnishing of sports programs, gross income does not include amounts received as proceeds from a sports program conducted by the taxpayer if—

(1) the taxpayer agrees in writing with the American National Red Cross to conduct such sports program exclusively for the benefit of the American National Red Cross;

(2) the taxpayer turns over to the American National Red Cross the proceeds from such sports program, minus the expenses paid or incurred by the taxpayer—

(A) which would not have been so paid or incurred but for such sports program, and

(B) which would be allowable as a deduction under section 162 (relating to trade or business expenses) but for subsection (b) of this section; and

(3) the facilities used for such program are not regularly used during the taxable year for the conduct of sports programs to which this subsection applies.

For purposes of this subsection, the term "proceeds from such sports program" includes all amounts paid for admission to the sports program, plus all proceeds received by the taxpayer from such program or activities carried on in connection therewith.

(b) TREATMENT OF EXPENSES.—Expenses described in subsection (a) (2) shall be allowed as a deduction under section 162 only to the extent that such expenses exceed the amount excluded from gross income by subsection (a) of this section.

SEC. 115. INCOME OF STATES, MUNICIPALITIES, ETC.

(a) GENERAL RULE.—Gross income does not include—

(1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or Territory, or any political subdivision thereof, or the District of Columbia; or

(2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

(b) CONTRACTS MADE BEFORE SEPTEMBER 8, 1916, RELATING TO PUBLIC UTILITIES.—Where a State or Territory, or any political subdivision thereof, or the District of Columbia, before September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which was to acquire, construct, operate, or maintain a public utility—

(1) If—

(A) by the terms of such contract the tax imposed by this subtitle is to be paid out of the proceeds from the operation of such public utility before any division of such proceeds between the person and the State, Territory, political subdivision, or the District of Columbia, and

(B) a part of such proceeds for the taxable year would (but for the imposition of the tax imposed by this subtitle) accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia,

then a tax on the taxable income from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle, but there shall be refunded to such State, Territory, political subdivision, or the District of Columbia (under regulations prescribed by the Secretary or his delegate) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this subtitle) would have accrued directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, bears to the amount of the taxable income from the operation of such public utility for such taxable year.

(2) If by the terms of such contract no part of the proceeds from the operation of the public utility for the taxable year would, irrespective of the tax imposed by this subtitle, accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then the tax on the taxable income of such person from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle.

(c) CONTRACTS MADE BEFORE MAY 29, 1928, RELATING TO BRIDGE ACQUISITIONS.—Where a State or political subdivision thereof, pursuant to a contract entered into before May 29, 1928, to which it is not a party, is to acquire a bridge—

(1) If—

(A) by the terms of such contract the tax imposed by this subtitle is to be paid out of the proceeds from the operation of such bridge before any division of such proceeds, and

(B) a part of such proceeds for the taxable year would (but for the imposition of the tax imposed by this subtitle) accrue directly to or for the use of or would be applied for the benefit of such State or political subdivision,

then a tax on the taxable income from the operation of such bridge shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle, but there shall be refunded to such State or political subdivision (under regulations to be prescribed by the Secretary or his delegate) an amount which bears the same

relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this subtitle) would have accrued directly to or for the use of or would be applied for the benefit of such State or political subdivision bears to the amount of the taxable income from the operation of such bridge for such taxable year. No such refund shall be made unless the entire amount of the refund is to be applied in part payment for the acquisition of such bridge.

(2) If by the terms of such contract no part of the proceeds from the operation of the bridge for the taxable year would, irrespective of the tax imposed by this subtitle, accrue directly to or for the use of or be applied for the benefit of such State or political subdivision, then the tax on the taxable income from the operation of such bridge shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle.

SEC. 116. PARTIAL EXCLUSION OF DIVIDENDS RECEIVED BY INDIVIDUALS.

(a) EXCLUSION FROM GROSS INCOME.—Effective with respect to any taxable year ending after July 31, 1954, gross income does not include amounts received by an individual as dividends from domestic corporations, to the extent that the dividends do not exceed $50. If the dividends received in a taxable year exceed $50, the exclusion provided by the preceding sentence shall apply to the dividends first received in such year.

(b) CERTAIN DIVIDENDS EXCLUDED.—Subsection (a) shall not apply to any dividend from—

(1) an insurance company subject to a tax imposed by part I or II of subchapter L (sec. 801 and following);

(2) a corporation organized under the China Trade Act, 1922 (see sec. 941); or

(3) a corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is—

(A) a corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or

(B) a corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

(c) SPECIAL RULES FOR CERTAIN DISTRIBUTIONS.—For purposes of subsection (a)—

(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

(2) A dividend received from a regulated investment company shall be subject to the limitations prescribed in section 854.

(d) CERTAIN NONRESIDENT ALIENS INELIGIBLE FOR EXCLUSION.—Subsection (a) does not apply to a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section 871 (a).

SEC. 117. SCHOLARSHIPS AND FELLOWSHIP GRANTS.

(a) GENERAL RULE.—In the case of an individual, gross income does not include—

(1) any amount received—

(A) as a scholarship at an educational institution (as defined in section 151 (e) (4)), or

(B) as a fellowship grant,

including the value of contributed services and accommodations; and

(2) any amount received to cover expenses for—

(A) travel,

(B) research,

(C) clerical help, or

(D) equipment,

which are incident to such a scholarship or to a fellowship grant, but only to the extent that the amount is so expended by the recipient.

(b) LIMITATIONS.—

(1) INDIVIDUALS WHO ARE CANDIDATES FOR DEGREES.—In the case of an individual who is a candidate for a degree at an educational institution (as defined in section 151 (e) (4)), subsection (a) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or the fellowship grant. If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving such degree, such teaching, research, or other services shall not be regarded as part-time employment within the meaning of this paragraph.

(2) INDIVIDUALS WHO ARE NOT CANDIDATES FOR DEGREES.—In the case of an individual who is not a candidate for a degree at an educational institution (as defined in section 151 (e) (4)), subsection (a) shall apply only if the condition in subparagraph (A) is satisfied and then only within the limitations provided in subparagraph (B).

(A) CONDITIONS FOR EXCLUSION.—The grantor of the scholarship or fellowship grant is an organization described in section 501 (c) (3) which is exempt from tax under section 501 (a), the United States, or an instrumentality or agency thereof, or a State, a Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(B) EXTENT OF EXCLUSION.—The amount of the scholarship or fellowship grant excluded under subsection (a) (1) in any taxable year shall be limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in section 151 (e) (4)).

SEC. 118. CONTRIBUTIONS TO THE CAPITAL OF A CORPORATION.

(a) GENERAL RULE.—In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) CROSS REFERENCE.—

For basis of property acquired by a corporation through a contribution to its capital, see section 362.

SEC. 119. MEALS OR LODGING FURNISHED FOR THE CONVENIENCE OF THE EMPLOYER.

There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—

(1) in the case of meals, the meals are furnished on the business premises of the employer, or

(2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

In determining whether meals or lodging are furnished for the convenience of the employer, the provisions of an employment contract or of a State statute fixing terms of employment shall not be determinative of whether the meals or lodging are intended as compensation.

SEC. 120. STATUTORY SUBSISTENCE ALLOWANCE RECEIVED BY POLICE.

(a) GENERAL RULE.—Gross income does not include any amount received as a statutory subsistence allowance by an individual who is employed as a police official by a State, a Territory, or a possession of the United States, by any political subdivision of any of the foregoing, or by the District of Columbia.

(b) LIMITATIONS.—

(1) Amounts to which subsection (a) applies shall not exceed $5 per day.

(2) If any individual receives a subsistence allowance to which subsection (a) applies, no deduction shall be allowed under any other provision of this chapter for expenses in respect of which he has received such allowance, except to the extent that such expenses exceed the amount excludable under subsection (a) and the excess is otherwise allowable as a deduction under this chapter.

SEC. 121. CROSS REFERENCES TO OTHER ACTS.

(a) For exemption of—

(1) Adjustments of indebtedness under wage earners' plans, see section 679 of the Bankruptcy Act (52 Stat. 938; 11 U. S. C. 1079);

(2) Allowances and expenditures to meet losses sustained by persons serving the United States abroad, due to appreciation of foreign currencies, see the Acts of March 6, 1934 (48 Stat. 466; 5 U. S. C. 118c) and April 25, 1938 (52 Stat. 221; 5 U. S. C. 118c–1);

(3) Amounts credited to the Maritime Administration under section 9 (b) (6) of the Merchant Ship Sales Act of 1946, see section 9 (c) (1) of that Act (60 Stat. 48; 50 U. S. C. App. 1742);

(4) Benefits under World War Adjusted Compensation Act, see section 308 of that Act, as amended (43 Stat. 125; 44 Stat. 827, § 3; 38 U. S. C. 618);

(5) Benefits under World War Veterans' Act, 1924, see section 3 of the Act of August 12, 1935 (49 Stat. 609; 38 U. S. C. 454a);

(6) Dividends and interest derived from certain preferred stock by Reconstruction Finance Corporation, see section 304 of the Act of March 9, 1933, as amended (49 Stat. 1185; 12 U. S. C. 51d);

(7) Earnings of ship contractors deposited in special reserve funds, see section 607 (h) of the Merchant Marine Act, 1936, as amended (52 Stat. 961, § 28; 46 U. S. C. 1177);

(8) Income derived from Federal Reserve banks, including capital stock and surplus, see section 7 of the Federal Reserve Act (38 Stat. 258; 12 U. S. C. 531);

(9) Income derived from Ogdensburg bridge across Saint Lawrence River, see section 4 of the Act of June 14, 1933, as amended (54 Stat. 259, § 2);

(10) Income derived from Owensboro bridge across Ohio River and nearby ferries, see section 4 of the Act of August 14, 1937 (50 Stat. 643);

(11) Income derived from Saint Clair River bridge and ferries, see section 4 of the Act of June 25, 1930, as amended (48 Stat. 140, § 1);

(12) Leave compensation payments under section 6 of Armed Forces Leave Act of 1946, see section 7 of that Act (60 Stat. 967; 37 U. S. C. 36);

(13) Mustering-out payments made to or on account of veterans under the Mustering-Out Payment Act of 1944, see section 5 (a) of that Act (58 Stat. 10; 38 U. S. C. 691e);

(14) Railroad retirement annuities and pensions, see section 12 of the Railroad Retirement Act of 1935, as amended (50 Stat. 316; 45 U. S. C. 228l);

(15) Railroad unemployment benefits, see section 2 (e) of the Railroad Unemployment Insurance Act, as amended (52 Stat. 1097; 53 Stat. 845, § 9; 45 U. S. C. 352);

(16) Special pensions of persons on Army and Navy medal of honor roll, see section 3 of the Act of April 27, 1916 (39 Stat. 54; 38 U. S. C. 393);

(17) Gain derived from the sale or other disposition of Treasury Bills, issued after June 17, 1930, under the Second Liberty Bond Act, as amended, see Act of June 17, 1930 (C. 512, 46 Stat. 775; 31 U. S. C. 754).

(b) For extension of military income-tax-exemption benefits to commissioned officers of Public Health Service in certain circumstances, see section 212 of the Public Health Service Act (58 Stat. 689; 42 U. S. C. 213).

PART IV—STANDARD DEDUCTION FOR INDIVIDUALS

Sec. 141. Standard deduction.
Sec. 142. Individuals not eligible for standard deduction.
Sec. 143. Determination of marital status.
Sec. 144. Election of standard deduction.
Sec. 145. Cross reference.

SEC. 141. STANDARD DEDUCTION.

The standard deduction referred to in section 63 (b) (defining taxable income in case of individual electing standard deduction) shall be an amount equal to 10 percent of the adjusted gross income or $1,000, whichever is the lesser, except that in the case of a separate return by a married individual the standard deduction shall not exceed $500.

SEC. 142. INDIVIDUALS NOT ELIGIBLE FOR STANDARD DEDUCTION.

(a) HUSBAND AND WIFE.—The standard deduction shall not be allowed to a husband or wife if the tax of the other spouse is determined under section 1 on the basis of the taxable income computed without regard to the standard deduction.

(b) CERTAIN OTHER TAXPAYERS INELIGIBLE.—The standard deduction shall not be allowed in computing the taxable income of—

(1) a nonresident alien individual;

(2) a citizen of the United States entitled to the benefits of section 931 (relating to income from sources within possessions of the United States);

(3) an individual making a return under section 443 (a) (1) for a period of less than 12 months on account of a change in his annual accounting period; or

(4) an estate or trust, common trust fund, or partnership.

SEC. 143. DETERMINATION OF MARITAL STATUS.

For purposes of this part—

(1) The determination of whether an individual is married shall be made as of the close of his taxable year; except that if his spouse dies during his taxable year such determination shall be made as of the time of such death; and

(2) An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

SEC. 144. ELECTION OF STANDARD DEDUCTION.

(a) METHOD AND EFFECT OF ELECTION.—

(1) If the adjusted gross income shown on the return is $5,000 or more, the standard deduction shall be allowed if the taxpayer so elects in his return, and the Secretary or his delegate shall by regulations prescribe the manner of signifying such election in the return. If the adjusted gross income shown on the return is $5,000 or more, but the correct adjusted gross income is less than $5,000, then an election by the taxpayer under the preceding sentence to take the standard deduction shall be considered as his election to pay the tax imposed by section 3 (relating to tax based on tax table); and his failure to make under the preceding sentence an election to take the standard deduction shall be considered his election not to pay the tax imposed by section 3.

(2) If the adjusted gross income shown on the return is less than $5,000, the standard deduction shall be allowed only if the taxpayer elects, in the manner provided in section 4, to pay the tax imposed by section 3. If the adjusted gross income shown on the return is less than $5,000, but the correct adjusted gross income is $5,000 or more, then an election by the taxpayer to pay the tax imposed by section 3 shall be considered as his election to take the standard deduction; and his failure to elect to pay the tax imposed by section 3 shall be considered his election not to take the standard deduction.

(3) If the taxpayer on making his return fails to signify, in the manner provided by paragraph (1) or (2), his election to take the standard deduction or to pay the tax imposed by section 3, as the case may be, such failure shall be considered his election not to take the standard deduction.

(b) CHANGE OF ELECTION.—Under regulations prescribed by the Secretary or his delegate, a change of an election for any taxable year to take, or not to take, the standard deduction, or to pay, or not to pay, the tax under section 3, may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding, for purposes of section 142 (a), to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations—

(1) the spouse makes a change of election with respect to the standard deduction for the taxable year covered in such separate

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return, consistent with the change of election sought by the taxpayer, and

(2) the taxpayer and his spouse consent in writing to the assessment, within such period as may be agreed on with the Secretary or his delegate, of any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

This subsection shall not apply if the tax liability of the taxpayer's spouse, for the taxable year corresponding (for purposes of section 142 (a)) to the taxable year of the taxpayer, has been compromised under section 7122.

SEC. 145. CROSS REFERENCE.

For disallowance of certain credits against the tax in the case of individuals electing the standard deduction, see section 36.

PART V—DEDUCTIONS FOR PERSONAL EXEMPTIONS

Sec. 151. Allowance of deductions for personal exemptions.
Sec. 152. Dependent defined.
Sec. 153. Determination of marital status.
Sec. 154. Gross references.

SEC. 151. ALLOWANCE OF DEDUCTIONS FOR PERSONAL EXEMPTIONS.

(a) ALLOWANCE OF DEDUCTIONS.—In the case of an individual, the exemptions provided by this section shall be allowed as deductions in computing taxable income.

(b) TAXPAYER AND SPOUSE.—An exemption of $600 for the taxpayer; and an additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

(c) ADDITIONAL EXEMPTION FOR TAXPAYER OR SPOUSE AGED 65 OR MORE.—

(1) FOR TAXPAYER.—An additional exemption of $600 for the taxpayer if he has attained the age of 65 before the close of his taxable year.

(2) FOR SPOUSE.—An additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse has attained the age of 65 before the close of such taxable year, and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

(d) ADDITIONAL EXEMPTION FOR BLINDNESS OF TAXPAYER OR SPOUSE.—

(1) FOR TAXPAYER.—An additional exemption of $600 for the taxpayer if he is blind at the close of his taxable year.

(2) FOR SPOUSE.—An additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. For purposes of this paragraph, the determination of whether the spouse is blind shall be made

as of the close of the taxable year of the taxpayer; except that if the spouse dies during such taxable year such determination shall be made as of the time of such death.

(3) BLINDNESS DEFINED.—For purposes of this subsection, an individual is blind only if his central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

(e) ADDITIONAL EXEMPTION FOR DEPENDENTS.—

(1) IN GENERAL.—An exemption of $600 for each dependent (as defined in section 152)—

(A) whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $600, or

(B) who is a child of the taxpayer and who (i) has not attained the age of 19 at the close of the calendar year in which the taxable year of the taxpayer begins, or (ii) is a student.

(2) EXEMPTION DENIED IN CASE OF CERTAIN MARRIED DEPENDENTS.—No exemption shall be allowed under this subsection for any dependent who has made a joint return with his spouse under section 6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.

(3) CHILD DEFINED.—For purposes of paragraph (1) (B), the term "child" means an individual who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer.

(4) STUDENT AND EDUCATIONAL INSTITUTION DEFINED.—For purposes of paragraph (1) (B) (ii), the term "student" means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins—

(A) is a full-time student at an educational institution; or

(B) is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a State or political subdivision of a State.

For purposes of this paragraph, the term "educational institution" means only an educational institution which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on.

SEC. 152. DEPENDENT DEFINED.

(a) GENERAL DEFINITION.—For purposes of this subtitle, the term "dependent" means any of the following individuals over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer (or is treated under subsection (c) as received from the taxpayer):

(1) A son or daughter of the taxpayer, or a descendant of either,

(2) A stepson or stepdaughter of the taxpayer,

(3) A brother, sister, stepbrother, or stepsister of the taxpayer,

(4) The father or mother of the taxpayer, or an ancestor of either,

(5) A stepfather or stepmother of the taxpayer,

(6) A son or daughter of a brother or sister of the taxpayer,

(7) A brother or sister of the father or mother of the taxpayer,

(8) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer,

(9) An individual who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household, or

(10) An individual who—

(A) is a descendant of a brother or sister of the father or mother of the taxpayer,

(B) for the taxable year of the taxpayer receives institutional care required by reason of a physical or mental disability, and

(C) before receiving such institutional care, was a member of the same household as the taxpayer.

(b) RULES RELATING TO GENERAL DEFINITION.—For purposes of this section—

(1) The terms "brother" and "sister" include a brother or sister by the halfblood.

(2) In determining whether any of the relationships specified in subsection (a) or paragraph (1) of this subsection exists, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(3) The term "dependent" does not include any individual who is not a citizen of the United States unless such individual is a resident of the United States, of a country contiguous to the United States, of the Canal Zone, or of the Republic of Panama. The preceding sentence shall not exclude from the definition of "dependent" any child of the taxpayer born to him, or legally adopted by him, in the Philippine Islands before July 5, 1946, if the child is a resident of the Republic of the Philippines, and if the taxpayer was a member of the Armed Forces of the United States at the time the child was born to him or legally adopted by him.

(4) A payment to a wife which is includible in the gross income of the wife under section 71 or 682 shall not be treated as a payment by her husband for the support of any dependent.

(c) MULTIPLE SUPPORT AGREEMENTS.—For purposes of subsection (a), over half of the support of an individual for a calendar year shall be treated as received from the taxpayer if—

(1) no one person contributed over half of such support;

(2) over half of such support was received from persons each of whom, but for the fact that he did not contribute over half of such support, would have been entitled to claim such individual as a dependent for a taxable year beginning in such calendar year;

(3) the taxpayer contributed over 10 percent of such support; and

(4) each person described in paragraph (2) (other than the taxpayer) who contributed over 10 percent of such support files a written declaration (in such manner and form as the Secretary or his delegate may by regulations prescribe) that he will not claim such individual as a dependent for any taxable year beginning in such calendar year.

(d) SPECIAL SUPPORT TEST IN CASE OF STUDENTS.—For purposes of subsection (a), in the case of any individual who is—

(1) a son, stepson, daughter, or stepdaughter of the taxpayer (within the meaning of this section), and

(2) a student (within the meaning of section 151 (e) (4)),

amounts received as scholarships for study at an educational institution (as defined in section 151 (e) (4)) shall not be taken into account in determining whether such individual received more than half of his support from the taxpayer.

SEC. 153. DETERMINATION OF MARITAL STATUS.

For purposes of this part—

(1) The determination of whether an individual is married shall be made as of the close of his taxable year; except that if his spouse dies during his taxable year such determination shall be made as of the time of such death; and

(2) An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

SEC. 154. CROSS REFERENCES.

(1) For definitions of "husband" and "wife", as used in section 152 (b) (4), see section 7701 (a) (17).

(2) For deductions of estates and trusts, in lieu of the exemptions under section 151, see section 642 (b).

(3) For exemptions of nonresident aliens, see section 873 (d).

(4) For exemptions of citizens deriving income mainly from sources within possessions of the United States, see section 931 (e).

PART VI—ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

Sec. 161. Allowance of deductions.
Sec. 162. Trade or business expenses.
Sec. 163. Interest.
Sec. 164. Taxes.
Sec. 165. Losses.
Sec. 166. Bad debts.
Sec. 167. Depreciation.
Sec. 168. Amortization of emergency facilities.
Sec. 169. Amortization of grain-storage facilities.
Sec. 170. Charitable, etc., contributions and gifts.
Sec. 171. Amortizable bond premium.
Sec. 172. Net operating loss deduction.
Sec. 173. Circulation expenditures.
Sec. 174. Research and experimental expenditures.
Sec. 175. Soil and water conservation expenditures.

SEC. 161. ALLOWANCE OF DEDUCTIONS.

In computing taxable income under section 63 (a), there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible).

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.—There shall 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, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

(b) CHARITABLE CONTRIBUTIONS AND GIFTS EXCEPTED.—No deduction shall be allowed under subsection (a) for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, or the requirements as to the time of payment, set forth in such section.

(c) CROSS REFERENCE.—

For special rule relating to expenses in connection with subdividing real property for sale, see section 1237.

SEC. 163. INTEREST.

(a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

(b) INSTALLMENT PURCHASES WHERE INTEREST CHARGE IS NOT SEPARATELY STATED.—

(1) GENERAL RULE.—If personal property is purchased under a contract—

(A) which provides that payment of part or all of the purchase price is to be made in installments, and

(B) in which carrying charges are separately stated but the interest charge cannot be ascertained,

then the payments made during the taxable year under the contract shall be treated for purposes of this section as if they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

(2) LIMITATION.—In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

(c) CROSS REFERENCES.—

(1) For disallowance of certain amounts paid in connection with insurance, endowment, or annuity contracts, see section 264.

(2) For disallowance of deduction for interest relating to tax-exempt income, see section 265 (2).

(3) For disallowance of deduction for carrying charges chargeable to capital account, see section 266.

(4) For disallowance of interest with respect to transactions between related taxpayers, see section 267.

SEC. 164. TAXES.

(a) GENERAL RULE.—Except as otherwise provided in this section, there shall be allowed as a deduction taxes paid or accrued within the taxable year.

(b) DEDUCTION DENIED IN CASE OF CERTAIN TAXES.—No deduction shall be allowed for the following taxes:

(1) Federal income taxes, including—

(A) the tax imposed by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act);

(B) the taxes imposed by sections 3201 and 3211 (relating to the taxes on railroad employees and railroad employee representatives); and

(C) the tax withheld at source on wages under section 3402, and corresponding provisions of prior revenue laws.

(2) Federal war profits and excess profits taxes.

(3) Federal import duties, and Federal excise and stamp taxes (not described in paragraph (1), (2), (4), or (5)); but this paragraph shall not prevent such duties and taxes from being deducted under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income).

(4) Estate, inheritance, legacy, succession, and gift taxes.

(5) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not prevent—

(A) the deduction of so much of such taxes as is properly allocable to maintenance or interest charges; or

(B) the deduction of taxes levied by a special taxing district if—

(i) the district covers the whole of at least one county;

(ii) at least 1,000 persons are subject to the taxes levied by the district; and

(iii) the district levies its assessments annually at a uniform rate on the same assessed value of real property, including improvements, as is used for purposes of the real property tax generally.

(6) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901 (relating to the foreign tax credit).

(7) Taxes on real property, to the extent that subsection (d) requires such taxes to be treated as imposed on another taxpayer.

(c) CERTAIN RETAIL SALES TAXES AND GASOLINE TAXES.—

(1) GENERAL RULE.—In the case of any State or local sales tax, if the amount of the tax is separately stated, then, to the extent that the amount so stated is paid by the consumer (otherwise than in connection with the consumer's trade or business) to his seller, such amount shall be allowed as a deduction to the consumer as if it constituted a tax imposed on, and paid by, such consumer.

(2) DEFINITION.—For purposes of paragraph (1), the term "State or local sales tax" means a tax imposed by a State, a Territory, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia, which tax—

(A) is imposed on persons engaged in selling tangible personal property at retail (or on persons selling gasoline or other motor vehicle fuels at wholesale or retail) and is a stated sum per unit of property sold or is measured either by the gross sales price or by the gross receipts from the sale; or

(B) is imposed on persons engaged in furnishing services at retail and is measured by the gross receipts for furnishing such services.

(d) APPORTIONMENT OF TAXES ON REAL PROPERTY BETWEEN SELLER AND PURCHASER.—

(1) GENERAL RULE.—For purposes of subsection (a), if real property is sold during any real property tax year, then—

(A) so much of the real property tax as is properly allocable to that part of such year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, and

(B) so much of such tax as is properly allocable to that part of such year which begins on the date of the sale shall be treated as a tax imposed on the purchaser.

(2) SPECIAL RULES.—

(A) In the case of any sale of real property, if—

(i) a taxpayer may not, by reason of his method of accounting, deduct any amount for taxes unless paid, and

(ii) the other party to the sale is (under the law imposing the real property tax) liable for the real property tax for the real property tax year,

then for purposes of subsection (a) the taxpayer shall be treated as having paid, on the date of the sale, so much of such tax as, under paragraph (1) of this subsection, is treated as imposed on the taxpayer. For purposes of the preceding sentence, if neither party is liable for the tax, then the party holding the property at the time the tax becomes a lien on the property shall be considered liable for the real property tax for the real property tax year.

(B) Paragraph (1) shall apply to taxable years ending after December 31, 1953, but only in the case of sales after December 31, 1953.

(C) Paragraph (1) shall not apply to any real property tax, to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 to the seller for a taxable year which ended before January 1, 1954.

(D) In the case of any sale of real property, if the taxpayer's taxable income for the taxable year during which the sale occurs is computed under an accrual method of accounting, and if no election under section 461 (c) (relating to the accrual of real property taxes) applies, then, for purposes of subsection (a), that portion of such tax which—

(i) is treated, under paragraph (1) of this subsection, as imposed on the taxpayer, and

(ii) may not, by reason of the taxpayer's method of accounting, be deducted by the taxpayer for any taxable year,

shall be treated as having accrued on the date of the sale.

(e) TAXES OF SHAREHOLDER PAID BY CORPORATION.—Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

(f) CROSS REFERENCE.—

For provisions disallowing any deduction for the payment of the tax imposed by subchapter B of chapter 3 (relating to tax-free covenant bonds) see section 1451 (f).

SEC. 165. LOSSES.

(a) GENERAL RULE.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) AMOUNT OF DEDUCTION.—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) LIMITATION ON LOSSES OF INDIVIDUALS.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. No loss described in this paragraph shall be allowed if, at the time of the filing of the return, such loss has been claimed for estate tax purposes in the estate tax return.

(d) WAGERING LOSSES.—Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) THEFT LOSSES.—For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

(f) CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) WORTHLESS SECURITIES.—

(1) GENERAL RULE.—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) SECURITY DEFINED.—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) SECURITIES IN AFFILIATED CORPORATION.—For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental from properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

(h) CROSS REFERENCES.—

(1) For special rule for banks with respect to worthless securities, see section 582.

(2) For disallowance of deduction for worthlessness of securities to which subsection (g) (2) (C) applies, if issued by a political party or similar organization, see section 271.

SEC. 166. BAD DEBTS.

(a) GENERAL RULE.—

(1) WHOLLY WORTHLESS DEBTS.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) PARTIALLY WORTHLESS DEBTS.—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) AMOUNT OF DEDUCTION.—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) RESERVE FOR BAD DEBTS.—In lieu of any deduction under subsection (a), 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.

(d) NONBUSINESS DEBTS.—

(1) GENERAL RULE.—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) NONBUSINESS DEBT DEFINED.—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a taxpayer's trade or business; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) WORTHLESS SECURITIES.—This section shall not apply to a debt which is evidenced by a security as defined in section 165 (g) (2) (C).

(f) GUARANTOR OF CERTAIN NONCORPORATE OBLIGATIONS.—A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment.

(g) CROSS REFERENCES.—

(1) For disallowance of deduction for worthlessness of debts owed by political parties and similar organizations, see section 271.

(2) For special rule for banks with respect to worthless securities, see section 582.

(3) For special rule for bad debt reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see section 593.

SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) USE OF CERTAIN METHODS AND RATES.—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

(c) LIMITATIONS ON USE OF CERTAIN METHODS AND RATES.—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

(1) the construction, reconstruction, or erection of which is completed after December 31, 1953, and then only to that portion of the basis which is properly attributable to such construction, reconstruction, or erection after December 31, 1953, or

(2) acquired after December 31, 1953, if the original use of such property commences with the taxpayer and commences after such date.

(d) AGREEMENT AS TO USEFUL LIFE ON WHICH DEPRECIATION RATE IS BASED.—Where, under regulations prescribed by the Secretary or his delegate, the taxpayer and the Secretary or his delegate have, after the date of enactment of this title, entered into an agreement in writing specifically dealing with the useful life and rate of depreciation of any property, the rate so agreed upon shall be binding on both the taxpayer and the Secretary in the absence of facts or circumstances not taken into consideration in the adoption of such agreement. The responsibility of establishing the existence of such facts and circumstances shall rest with the party initiating the modification. Any change in the agreed rate and useful life specified in the agreement shall not be effective for taxable years before the taxable year in which notice in writing by registered mail is served by the party to the agreement initiating such change.

(e) CHANGE IN METHOD.—In the absence of an agreement under subsection (d) containing a provision to the contrary, a taxpayer may at any time elect in accordance with regulations prescribed by the Secretary or his delegate to change from the method of depreciation described in subsection (b) (2) to the method described in subsection (b) (1).

(f) BASIS FOR DEPRECIATION.—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

(g) LIFE TENANTS AND BENEFICIARIES OF TRUSTS AND ESTATES.—In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

(h) DEPRECIATION OF IMPROVEMENTS IN THE CASE OF MINES, ETC.—

For additional rule applicable to depreciation of improvements in the case of mines, oil and gas wells, other natural deposits, and timber, see section 611.

SEC. 168. AMORTIZATION OF EMERGENCY FACILITIES.

(a) GENERAL RULE.—Every person, at his election, shall be entitled to a deduction with respect to the amortization of the adjusted

basis (for determining gain) of any emergency facility (as defined in subsection (d)), based on a period of 60 months. Such amortization deduction shall be an amount, with respect to each month of such period within the taxable year, equal to the adjusted basis of the facility at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such adjusted basis at the end of the month shall be computed without regard to the amortization deduction for such month. The amortization deduction above provided with respect to any month shall, except to the extent provided in subsection (f), be in lieu of the depreciation deduction with respect to such facility for such month provided by section 167. The 60-month period shall begin as to any emergency facility, at the election of the taxpayer, with the month following the month in which the facility was completed or acquired, or with the succeeding taxable year.

(b) ELECTION OF AMORTIZATION.—The election of the taxpayer to take the amortization deduction and to begin the 60-month period with the month following the month in which the facility was completed or acquired, or with the taxable year succeeding the taxable year in which such facility was completed or acquired, shall be made by filing with the Secretary or his delegate, in such manner, in such form, and within such time, as the Secretary or his delegate may by regulations prescribe, a statement of such election.

(c) TERMINATION OF AMORTIZATION DEDUCTION.—A taxpayer which has elected under subsection (b) to take the amortization deduction provided in subsection (a) may, at any time after making such election, discontinue the amortization deduction with respect to the remainder of the amortization period, such discontinuance to begin as of the beginning of any month specified by the taxpayer in a notice in writing filed with the Secretary or his delegate before the beginning of such month. The depreciation deduction provided under section 167 shall be allowed, beginning with the first month as to which the amortization deduction does not apply, and the taxpayer shall not be entitled to any further amortization deduction with respect to such emergency facility.

(d) DEFINITIONS.—

(1) EMERGENCY FACILITY.—For purposes of this section, the term "emergency facility" means any facility, land, building, machinery, or equipment, or any part thereof, the construction, reconstruction, erection, installation, or acquisition of which was completed after December 31, 1949, and with respect to which a certificate under subsection (e) has been made. In no event shall an amortization deduction be allowed in respect of any emergency facility for any taxable year unless a certificate in respect thereof under this paragraph shall have been made before the filing of the taxpayer's return for such taxable year.

(2) EMERGENCY PERIOD.—For purposes of this section, the term "emergency period" means the period beginning January 1, 1950, and ending on the date on which the President proclaims that the utilization of a substantial portion of the emergency facilities with respect to which certifications under subsection (e) have been made is no longer required in the interest of national defense.

(e) DETERMINATION OF ADJUSTED BASIS OF EMERGENCY FACILITY.—In determining, for purposes of subsection (a) or (g), the adjusted basis of an emergency facility—

(1) There shall be included only so much of the amount of the adjusted basis of such facility (computed without regard to this section) as is properly attributable to such construction, reconstruction, erection, installation, or acquisition after December 31, 1949, as the certifying authority, designated by the President by Executive Order, has certified as necessary in the interest of national defense during the emergency period, and only such portion of such amount as such authority has certified as attributable to defense purposes. Such certification shall be under such regulations as may be prescribed from time to time by such certifying authority with the approval of the President. An application for a certificate must be filed at such time and in such manner as may be prescribed by such certifying authority under such regulations, but in no event shall such certificate have any effect unless an application therefor is filed before March 24, 1951, or before the expiration of 6 months after the beginning of such construction, reconstruction, erection, or installation or the date of such acquisition, whichever is later.

(2) After the completion or acquisition of any emergency facility with respect to which a certificate under paragraph (1) has been made, any expenditure (attributable to such facility and to the period after such completion or acquisition) which does not represent construction, reconstruction, erection, installation, or acquisition included in such certificate, but with respect to which a separate certificate is made under paragraph (1), shall not be applied in adjustment of the basis of such facility, but a separate basis shall be computed therefor pursuant to paragraph (1) as if it were a new and separate emergency facility.

(f) DEPRECIATION DEDUCTION.—If the adjusted basis of the emergency facility (computed without regard to this section) is in excess of the adjusted basis computed under subsection (e), the depreciation deduction provided by section 167 shall, despite the provisions of subsection (a) of this section, be allowed with respect to such emergency facility as if its adjusted basis for the purpose of such deduction were an amount equal to the amount of such excess.

(g) PAYMENT BY UNITED STATES OF UNAMORTIZED COST OF FACILITY.—If an amount is properly includible in the gross income of the taxpayer on account of a payment with respect to an emergency facility and such payment is certified as provided in paragraph (1), then, at the election of the taxpayer in its return for the taxable year in which such amount is so includible—

(1) The amortization deduction for the month in which such amount is so includible shall (in lieu of the amount of the deduction for such month computed under subsection (a)) be equal to the amount so includible but not in excess of the adjusted basis of the emergency facility as of the end of such month (computed without regard to any amortization deduction for such month). Payments referred to in this subsection shall be payments the amounts of which are certified, under such regulations as the President may

prescribe, by the certifying authority designated by the President as compensation to the taxpayer for the unamortized cost of the emergency facility made because—

(A) a contract with the United States involving the use of the facility has been terminated by its terms or by cancellation, or

(B) the taxpayer had reasonable ground (either from provisions of a contract with the United States involving the use of the facility, or from written or oral representations made under authority of the United States) for anticipating future contracts involving the use of the facility, which future contracts have not been made.

(2) In case the taxpayer is not entitled to any amortization deduction with respect to the emergency facility, the depreciation deduction allowable under section 167 on account of the month in which such amount is so includible shall be increased by such amount, but such deduction on account of such month shall not be in excess of the adjusted basis of the emergency facility as of the end of such month (computed without regard to any amount allowable, on account of such month, under section 167 or this paragraph).

(h) LIFE TENANT AND REMAINDERMAN.—In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant.

(i) CROSS REFERENCE.—

For special rule with respect to gain derived from the sale or exchange of property the adjusted basis of which is determined with regard to this section, see section 1238.

SEC. 169. AMORTIZATION OF GRAIN-STORAGE FACILITIES.

(a) ALLOWANCE OF DEDUCTION.—

(1) ORIGINAL OWNER.—Any person who constructs, reconstructs, or erects a grain-storage facility (as defined in subsection (d)) shall, at his election, be entitled to a deduction with respect to the amortization of the adjusted basis (for determining gain) of such facility based on a period of 60 months. The 60-month period shall begin as to any such facility, at the election of the taxpayer, with the month following the month in which the facility was completed, or with the succeeding taxable year.

(2) SUBSEQUENT OWNERS.—Any person who acquires a grain-storage facility from a taxpayer who—

(A) elected under subsection (b) to take the amortization deduction provided by this subsection with respect to such facility, and

(B) did not discontinue the amortization deduction pursuant to subsection (c),

shall, at his election, be entitled to a deduction with respect to the adjusted basis (determined under subsection (e) (2)) of such facility based on the period, if any, remaining (at the time of acquisition) in the 60-month period elected under subsection (b) by the person who constructed, reconstructed, or erected such facility.

(3) AMOUNT OF DEDUCTION.—The amortization deduction provided in paragraphs (1) and (2) shall be an amount, with respect to each month of the amortization period within the taxable year, equal to the adjusted basis of the facility at the end of such month, divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such adjusted basis at the end of the month shall be computed without regard to the amortization deduction for such month. The amortization deduction above provided with respect to any month shall be in lieu of the depreciation deduction with respect to such facility for such month provided by section 167.

(b) ELECTION OF AMORTIZATION.—The election of the taxpayer under subsection (a) (1) to take the amortization deduction and to begin the 60-month period with the month following the month in which the facility was completed shall be made only by a statement to that effect in the return for the taxable year in which the facility was completed. The election of the taxpayer under subsection (a) (1) to take the amortization deduction and to begin such period with the taxable year succeeding such year shall be made only by a statement to that effect in the return for such succeeding taxable year. The election of the taxpayer under subsection (a) (2) to take the amortization deduction shall be made only by a statement to that effect in the return for the taxable year in which the facility was acquired. Notwithstanding the preceding three sentences, the election of the taxpayer under subsection (a) (1) or (2) may be made, under such regulations as the Secretary or his delegate may prescribe, before the time prescribed in the applicable sentence.

(c) TERMINATION OF AMORTIZATION DEDUCTION.—A taxpayer which has elected under subsection (b) to take the amortization deduction provided in subsection (a) may, at any time after making such election, discontinue the amortization deduction with respect to the remainder of the amortization period, such discontinuance to begin as of the beginning of any month specified by the taxpayer in a notice in writing filed with the Secretary or his delegate before the beginning of such month. The depreciation deduction provided under section 167 shall be allowed, beginning with the first month as to which the amortization deduction does not apply, and the taxpayer shall not be entitled to any further amortization deduction with respect to such facility.

(d) DEFINITION OF GRAIN-STORAGE FACILITY.—For purposes of this section, the term "grain-storage facility" means—

(1) any corn crib, grain bin, or grain elevator, or any similar structure suitable primarily for the storage of grain, which crib, bin, elevator, or structure is intended by the taxpayer at the time of his election to be used for the storage of grain produced by him (or, if the election is made by a partnership, produced by the members thereof); and

(2) any public grain warehouse permanently equipped for receiving, elevating, conditioning, and loading out grain,

the construction, reconstruction, or erection of which was completed after December 31, 1952, and on or before December 31, 1956. If any structure described in clause (1) or (2) of the preceding sentence is

altered or remodeled so as to increase its capacity for the storage of grain, or if any structure is converted, through alteration or remodeling, into a structure so described, and if such alteration or remodeling was completed after December 31, 1952, and on or before December 31, 1956, such alteration or remodeling shall be treated as the construction of a grain-storage facility. The term "grain-storage facility" shall include only property of a character which is subject to the allowance for depreciation provided in section 167. The term "grain-storage facility" shall not include any facility any part of which is an emergency facility within the meaning of section 168 of this title.

(e) DETERMINATION OF ADJUSTED BASIS.—

(1) ORIGINAL OWNERS.—For purposes of subsection (a) (1)—

(A) in determining the adjusted basis of any grain-storage facility, the construction, reconstruction, or erection of which was begun before January 1, 1953, there shall be included only so much of the amount of the adjusted basis (computed without regard to this subsection) as is properly attributable to such construction, reconstruction, or erection after December 31, 1952; and

(B) in determining the adjusted basis of any facility which is a grain-storage facility within the meaning of the second sentence of subsection (d), there shall be included only so much of the amount otherwise included in such basis as is properly attributable to the alteration or remodeling.

If any existing grain-storage facility as defined in the first sentence of subsection (d) is altered or remodeled as provided in the second sentence of subsection (d), the expenditures for such remodeling or alteration shall not be applied in adjustment of the basis of such existing facility but a separate basis shall be computed in respect of such facility as if the part altered or remodeled were a new and separate grain-storage facility.

(2) SUBSEQUENT OWNERS.—For purposes of subsection (a) (2), the adjusted basis of any grain-storage facility shall be whichever of the following amounts is the smaller:

(A) The basis (unadjusted) of such facility for purposes of this section in the hands of the transferor, donor, or grantor, adjusted as if such facility in the hands of the taxpayer had a substituted basis within the meaning of section 1016 (b), or

(B) so much of the adjusted basis (for determining gain) of the facility in the hands of the taxpayer (as computed without regard to this subsection) as is properly attributable to construction, reconstruction, or erection after December 31, 1952.

(f) DEPRECIATION DEDUCTION.—If the adjusted basis of the grain-storage facility (computed without regard to subsection (e)) exceeds the adjusted basis computed under subsection (e), the depreciation deduction provided by section 167 shall, despite the provisions of subsection (a) (3) of this section, be allowed with respect to such grain-storage facility as if the adjusted basis for the purpose of such deduction were an amount equal to the amount of such excess.

(g) LIFE TENANT AND REMAINDERMAN.—In the case of property held by one person for life with remainder to another person, the amortization deduction provided in subsection (a) shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

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SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(a) ALLOWANCE OF DEDUCTION.—

(1) GENERAL RULE.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary or his delegate.

(2) CORPORATIONS ON ACCRUAL BASIS.—In the case of a corporation reporting its taxable income on the accrual basis, if—

(A) the board of directors authorizes a charitable contribution during any taxable year, and

(B) payment of such contribution is made after the close of such taxable year and on or before the 15th day of the third month following the close of such taxable year,

then the taxpayer may elect to treat such contribution as paid during such taxable year. The election may be made only at the time of the filing of the return for such taxable year, and shall be signified in such manner as the Secretary or his delegate shall by regulations prescribe.

(b) LIMITATIONS.—

(1) INDIVIDUALS.—In the case of an individual the deduction provided in subsection (a) shall be limited as provided in subparagraphs (A), (B), (C), and (D).

(A) SPECIAL RULE.—Any charitable contribution to—

(i) a church or a convention or association of churches,

(ii) an educational organization referred to in section 503 (b) (2), or

(iii) a hospital referred to in section 503 (b) (5),

shall be allowed to the extent that the aggregate of such contributions does not exceed 10 percent of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback to the taxable year under section 172.

(B) GENERAL LIMITATION.—The total deductions under subsection (a) for any taxable year shall not exceed 20 percent of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback to the taxable year under section 172. For purposes of this subparagraph, the deduction under subsection (a) shall be computed without regard to any deduction allowed under subparagraph (A) but shall take into account any charitable contributions to the organizations described in clauses (i), (ii), and (iii) which are in excess of the amount allowable as a deduction under subparagraph (A).

(C) UNLIMITED DEDUCTION FOR CERTAIN INDIVIDUALS.—The limitation in subparagraph (B) shall not apply in the case of an individual if, in the taxable year and in 8 of the 10 preceding taxable years, the amount of the charitable contributions, plus the amount of income tax (determined without regard to chapter 2, relating to tax on self-employment income) paid during such year in respect of such year or preceding taxable years, exceeds 90 percent of the taxpayer's taxable income for such year, computed without regard to—

(i) this section,

(ii) section 151 (allowance of deductions for personal exemptions), and

(iii) any net operating loss carryback to the taxable year under section 172.

(D) DENIAL OF DEDUCTION IN CASE OF CERTAIN TRANSFERS IN TRUST.—No deduction shall be allowed under this section for the value of any interest in property transferred after March 9, 1954, to a trust if—

(i) the grantor has a reversionary interest in the corpus or income of that portion of the trust with respect to which a deduction would (but for this subparagraph) be allowable under this section; and

(ii) at the time of the transfer the value of such reversionary interest exceeds 5 percent of the value of the property constituting such portion of the trust.

For purposes of this subparagraph, a power exercisable by the grantor or a nonadverse party (within the meaning of section 672 (b)), or both, to revest in the grantor property or income therefrom shall be treated as a reversionary interest.

(2) CORPORATIONS.—In the case of a corporation, the total deductions under subsection (a) for any taxable year shall not exceed 5 percent of the taxpayer's taxable income computed without regard to—

(A) this section,

(B) part VIII (except section 248),

(C) any net operating loss carryback to the taxable year under section 172, and

(D) section 922 (special deduction for Western Hemisphere trade corporations).

Any contribution made by a corporation in a taxable year to which this section applies in excess of the amount deductible in such year under the foregoing limitation shall be deductible in each of the two succeeding taxable years in order of time, but only to the extent of the lesser of the two following amounts: (i) the excess of the maximum amount deductible for such succeeding taxable year under the foregoing limitation over the contributions made in such year; and (ii) in the case of the first succeeding taxable year the amount of such excess contribution, and in the case of the second succeeding taxable year the portion of such excess contribution not deductible in the first succeeding taxable year.

(c) CHARITABLE CONTRIBUTION DEFINED.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

(1) A State, a Territory, 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.

(2) A corporation, trust, or community chest, fund, or foundation—

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State or Territory, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B).

(3) A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization—

(A) organized in the United States or any of its possessions, and

(B) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(4) In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(5) A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual.

(d) DISALLOWANCE OF DEDUCTIONS IN CERTAIN CASES.—

(1) For disallowance of deductions in case of contributions or gifts to charitable organizations engaging in prohibited transactions, see section 503 (e).

(2) For disallowance of deductions for contributions to or for the use of communist controlled organizations, see section 11 (a) of the Internal Security Act of 1950 (64 Stat. 996; 50 U. S. C. 790).

(e) OTHER CROSS REFERENCES.—

(1) For charitable contributions of estates and trusts, see section 642 (c).

(2) For nondeductibility of contributions by common trust funds, see section 584.

(3) For charitable contributions of partners, see section 702.

(4) For charitable contributions of nonresident aliens, see section 873.

(5) For treatment of gifts for benefit of or use in connection with the Naval Academy as gifts to or for the use of the United States, see section 3 of the Act of March 31, 1944 (58 Stat. 135; 34 U. S. C. 1115b).

(6) For treatment of gifts for benefit of the library of the Post Office Department as gifts to or for the use of the United States, see section 2 of the Act of August 8, 1946 (60 Stat. 924; 5 U. S. C. 393).

(7) For treatment of gifts accepted by the Secretary of State under the Foreign Service Act of 1946 as gifts to or for the use of the United States, see section 1021 (e) of that Act (60 Stat. 1032; 22 U. S. C. 809 (e)).

(8) For treatment of gifts of money accepted by the Attorney General for credit to the "Commissary Funds Federal Prisons" as gifts to or

for the use of the United States, see section 2 of the Act of May 15, 1952 (66 Stat. 73, as amended by the Act of July 9, 1952, 66 Stat. 479, 31 U. S. C. 725s-4).

SEC. 171. AMORTIZABLE BOND PREMIUM.

(a) GENERAL RULE.—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond:

(1) INTEREST WHOLLY OR PARTIALLY TAXABLE.—In the case of a bond (other than a bond the interest on which is excludable from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) INTEREST WHOLLY TAX-EXEMPT.—In the case of any bond the interest on which is excludable from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) ADJUSTMENT OF CREDIT OR DEDUCTION FOR INTEREST PARTIALLY TAX-EXEMPT.—

(A) INDIVIDUALS.—In the case of any bond the interest on which is allowable as a credit under section 35, the amount which would otherwise be taken into account in computing such credit shall be reduced by the amount of the amortizable bond premium for the taxable year.

(B) CORPORATIONS.—In the case of any bond the interest on which is allowable as a deduction under section 242, such deduction shall be reduced by the amount of the amortizable bond premium for the taxable year.

(4) CROSS REFERENCE.—

For adjustment to basis on account of amortizable bond premium, see section 1016 (a) (5).

(b) AMORTIZABLE BOND PREMIUM.—

(1) AMOUNT OF BOND PREMIUM.—For purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined—

(A) with reference to the amount of the basis (for determining loss on sale or exchange) of such bond,

(B) with reference to the amount payable on maturity or on earlier call date (but in the case of bonds described in subsection (c) (1) (B) issued after January 22, 1951, and acquired after January 22, 1954, only if such earlier call date is a date more than 3 years after the date of such issue), and

(C) with adjustments proper to reflect unamortized bond premium, with respect to the bond, for the period before the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) AMOUNT AMORTIZABLE.—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year. In the case of a bond described in subsection (c) (1) (B) issued after January 22, 1951, and acquired after January 22, 1954, which has a call date not more than 3 years after the date of such issue, the amount of bond premium attributable to

the taxable year in which the bond is called shall include an amount equal to the excess of the amount of the adjusted basis (for determining loss on sale or exchange) of such bond as of the beginning of the taxable year over the amount received on redemption of the bond or (if greater) the amount payable on maturity.

(3) METHOD OF DETERMINATION.—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium prescribed by the Secretary or his delegate.

(c) ELECTION AS TO TAXABLE AND PARTIALLY TAXABLE BONDS.—

(1) ELIGIBILITY TO ELECT; BONDS WITH RESPECT TO WHICH ELECTION PERMITTED.—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply:

(A) PARTIALLY TAX-EXEMPT.—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 35 is allowable; and

(B) WHOLLY TAXABLE.—In the case of any taxpayer, bonds the interest on which is not excludable from gross income but with respect to which the credit provided in section 35, or the deduction provided in section 242, is not allowable.

(2) MANNER AND EFFECT OF ELECTION.—The election authorized under this subsection shall be made in accordance with such regulations as the Secretary or his delegate shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, on application by the taxpayer, the Secretary or his delegate permits him, subject to such conditions as the Secretary or his delegate deems necessary, to revoke such election. In the case of bonds held by a common trust fund, as defined in section 584 (a), or by a foreign personal holding company, as defined in section 552, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company. In case of bonds held by an estate or trust, the election authorized under this subsection shall be exercisable with respect to such bonds only by the fiduciary.

(d) BOND DEFINED.—For purposes of this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such

obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(e) DEALERS IN TAX-EXEMPT SECURITIES.—

For special rules applicable, in the case of dealers in securities, with respect to premium attributable to certain wholly tax-exempt securities, see section 75.

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) NET OPERATING LOSS CARRYBACKS AND CARRYOVERS.—

(1) YEARS TO WHICH LOSS MAY BE CARRIED.—A net operating loss for any taxable year ending after December 31, 1953, shall be—

(A) a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and

(B) 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 subsection (f), 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 7 taxable years to which (by reason of subparagraphs (A) and (B) of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other 6 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 without regard to the net operating loss for the loss year or for any taxable year thereafter,

and the taxable income so computed shall not be considered to be less than zero.

(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—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) DEDUCTION FOR PERSONAL EXEMPTIONS.—No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) NONBUSINESS DEDUCTIONS OF TAXPAYERS OTHER THAN CORPORATIONS.—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business,

shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2) (B), and (3) shall be taken into account; and

(C) any deduction allowable under section 165 (c) (3) (relating to casualty losses) shall not be taken into account.

(5) SPECIAL DEDUCTIONS FOR CORPORATIONS.—No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) COMPUTATION OF DEDUCTION FOR DIVIDENDS RECEIVED, ETC.—The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246 (b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a) (1) (B) of such section.

(e) LAW APPLICABLE TO COMPUTATIONS.—In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954.

(f) TAXABLE YEARS BEGINNING IN 1953 AND ENDING IN 1954.—In the case of a taxable year beginning in 1953 and ending in 1954—

(1) In lieu of the amount specified in subsection (c), the net operating loss for such year shall be the sum of—

(A) that portion of the net operating loss for such year computed without regard to this subsection which the number of days in the loss year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss for such year computed under section 122 of the Internal Revenue Code of 1939 as if this section had not been enacted which the number of days in the loss year before January 1, 1954, bears to the total number of days in such year.

(2) The amount of any net operating loss for such year which shall be carried to the second preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1953, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the second taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the second preceding taxable year.

(g) SPECIAL TRANSITIONAL RULES.—

(1) LOSSES FOR TAXABLE YEARS ENDING BEFORE JANUARY 1, 1954.—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.

(2) LOSSES FOR TAXABLE YEARS ENDING AFTER DECEMBER 31, 1953.—For purposes of section 122 of the Internal Revenue Code of 1939—

(A) the determination of the taxable years ending before January 1, 1954, to which a net operating loss for any taxable year ending after December 31, 1953, may be carried shall be made under subsection (b) (1) (A) of this section; and

(B) in determining the amount of the carryback to the first taxable year preceding the first taxable year ending after December 31, 1953, the portion of the net operating loss carried to such year shall be such net operating loss reduced by—

(i) the net income for the second preceding taxable year computed as if the second sentence of section 122 (b) (2) (B) of the Internal Revenue Code of 1939 applied, or

(ii) if smaller, the portion of the net operating loss which by reason of subsection (f) of this section is carried to the second preceding taxable year.

(3) EXCESS PROFITS TAX NOT AFFECTED.—For purposes of subchapter D of chapter 1 of the Internal Revenue Code of 1939, excess profits net income shall be computed as if this section had not been enacted and as if section 122 of such Code continued to apply to taxable years to which this subtitle applies.

(h) CROSS REFERENCES.—

(1) For treatment of net operating loss carryovers in certain corporate acquisitions, see section 381.

(2) For special limitation on net operating loss carryovers in case of a corporate change of ownership, see section 382.

SEC. 173. CIRCULATION EXPENDITURES.

Notwithstanding section 263, all expenditures (other than expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical) to establish, maintain, or increase the circulation of a newspaper, maga-

zine, or other periodical shall be allowed as a deduction; except that the deduction shall not be allowed with respect to the portion of such expenditures as, under regulations prescribed by the Secretary or his delegate, is chargeable to capital account if the taxpayer elects, in accordance with such regulations, to treat such portion as so chargeable. Such election, if made, must be for the total amount of such portion of the expenditures which is so chargeable to capital account, and shall be binding for all subsequent taxable years unless, upon application by the taxpayer, the Secretary or his delegate permits a revocation of such election subject to such conditions as he deems necessary.

SEC. 174. RESEARCH AND EXPERIMENTAL EXPENDITURES.

(a) TREATMENT AS EXPENSES.—

(1) IN GENERAL.—A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(2) WHEN METHOD MAY BE ADOPTED.—

(A) WITHOUT CONSENT.—A taxpayer may, without the consent of the Secretary or his delegate, adopt the method provided in this subsection for his first taxable year—

(i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and

(ii) for which expenditures described in paragraph (1) are paid or incurred.

(B) WITH CONSENT.—A taxpayer may, with the consent of the Secretary or his delegate, adopt at any time the method provided in this subsection.

(3) SCOPE.—The method adopted under this subsection shall apply to all expenditures described in paragraph (1). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method is authorized with respect to part or all of such expenditures.

(b) AMORTIZATION OF CERTAIN RESEARCH AND EXPERIMENTAL EXPENDITURES.—

(1) IN GENERAL.—At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, research or experimental expenditures which are—

(A) paid or incurred by the taxpayer in connection with his trade or business,

(B) not treated as expenses under subsection (a), and

(C) chargeable to capital account but not chargeable to property of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion),

may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Such deferred expenses

are expenditures properly chargeable to capital account for purposes of section 1016 (a) (1) (relating to adjustments to basis of property).

(2) TIME FOR AND SCOPE OF ELECTION.—The election provided by paragraph (1) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The method so elected, and the period selected by the taxpayer, shall be adhered to in computing taxable income for the taxable year for which the election is made and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method (or to a different period) is authorized with respect to part or all of such expenditures. The election shall not apply to any expenditure paid or incurred during any taxable year before the taxable year for which the taxpayer makes the election.

(c) LAND AND OTHER PROPERTY.—This section shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion); but for purposes of this section allowances under section 167, and allowances under section 611, shall be considered as expenditures.

(d) EXPLORATION EXPENDITURES.—This section shall not apply to any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).

(e) CROSS REFERENCE.—

For adjustments to basis of property for amounts allowed as deductions as deferred expenses under subsection (b), see section 1016 (a) (14).

SEC. 175. SOIL AND WATER CONSERVATION EXPENDITURES.

(a) IN GENERAL.—A taxpayer engaged in the business of farming may treat expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(b) LIMITATION.—The amount deductible under subsection (a) for any taxable year shall not exceed 25 percent of the gross income derived from farming during the taxable year. If for any taxable year the total of the expenditures treated as expenses which are not chargeable to capital account exceeds 25 percent of the gross income derived from farming during the taxable year, such excess shall be deductible for succeeding taxable years in order of time; but the amount deductible under this section for any one such succeeding taxable year (including the expenditures actually paid or incurred during the taxable year) shall not exceed 25 percent of the gross income derived from farming during the taxable year.

(c) DEFINITIONS.—For purposes of subsection (a)—

(1) The term "expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conserva-

tion in respect of land used in farming, or for the prevention of erosion of land used in farming" means expenditures paid or incurred for the treatment or moving of earth, including (but not limited to) leveling, grading and terracing, contour furrowing, the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds, the eradication of brush, and the planting of windbreaks. Such term does not include—

(A) the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation provided in section 167, or

(B) any amount paid or incurred which is allowable as a deduction without regard to this section.

Notwithstanding the preceding sentences, such term also includes any amount, not otherwise allowable as a deduction, paid or incurred to satisfy any part of an assessment levied by a soil or water conservation or drainage district to defray expenditures made by such district which, if paid or incurred by the taxpayer, would without regard to this sentence constitute expenditures deductible under this section.

(2) The term "land used in farming" means land used (before or simultaneously with the expenditures described in paragraph (1)) by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

(d) WHEN METHOD MAY BE ADOPTED.—

(1) WITHOUT CONSENT.—A taxpayer may, without the consent of the Secretary or his delegate, adopt the method provided in this section for his first taxable year—

(A) which begins after December 31, 1953, and ends after the date on which this title is enacted, and

(B) for which expenditures described in subsection (a) are paid or incurred.

(2) WITH CONSENT.—A taxpayer may, with the consent of the Secretary or his delegate, adopt at any time the method provided in this section.

(e) SCOPE.—The method adopted under this section shall apply to all expenditures described in subsection (a). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method is authorized with respect to part or all of such expenditures.

PART VII—ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

Sec. 211. Allowance of deductions.
Sec. 212. Expenses for production of income.
Sec. 213. Medical, dental, etc., expenses.
Sec. 214. Expenses for care of certain dependents.
Sec. 215. Alimony, etc., payments.
Sec. 216. Amounts representing taxes and interest paid to cooperative housing corporation.
Sec. 217. Cross references.

SEC. 211. ALLOWANCE OF DEDUCTIONS.

In computing taxable income under section 63 (a), there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (section 261 and following, relating to items not deductible).

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

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—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

SEC. 213. MEDICAL, DENTAL, ETC., EXPENSES.

(a) ALLOWANCE OF DEDUCTION.—There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in section 152)—

(1) if neither the taxpayer nor his spouse has attained the age of 65 before the close of the taxable year, to the extent that such expenses exceed 3 percent of the adjusted gross income; or

(2) if either the taxpayer or his spouse has attained the age of 65 before the close of the taxable year—

(A) the amount of such expenses for the care of the taxpayer and his spouse, and

(B) the amount by which such expenses for the care of such dependents exceed 3 percent of the adjusted gross income.

(b) LIMITATION WITH RESPECT TO MEDICINE AND DRUGS.—Amounts paid during the taxable year for medicine and drugs which (but for this subsection) would be taken into account in computing the deduction under subsection (a) shall be taken into account only to the extent that the aggregate of such amounts exceeds 1 percent of the adjusted gross income.

(c) MAXIMUM LIMITATIONS.—The deduction under this section shall not exceed $2,500, multiplied by the number of exemptions allowed for the taxable year as a deduction under section 151 (other than exemptions allowed by reason of subsection (c) or (d), relating to additional exemptions for age or blindness); except that the maximum deduction under this section shall be—

(1) $5,000, if the taxpayer is single and not the head of a household (as defined in section 1 (b) (2)) and not a surviving spouse

(as defined in section 2 (b)) or is married but files a separate return; or

(2) $10,000, if the taxpayer files a joint return with his spouse under section 6013, or is the head of a household (as defined in section 1 (b) (2)) or a surviving spouse (as defined in section 2 (b)).

(d) SPECIAL RULE FOR DECEDENTS.—

(1) TREATMENT OF EXPENSES PAID AFTER DEATH.—For purposes of subsection (a), expenses for the medical care of the taxpayer which are paid out of his estate during the 1-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time incurred.

(2) LIMITATION.—Paragraph (1) shall not apply if the amount paid is allowable under section 2053 as a deduction in computing the taxable estate of the decedent, but this paragraph shall not apply if (within the time and in the manner and form prescribed by the Secretary or his delegate) there is filed—

(A) a statement that such amount has not been claimed or allowed as a deduction under section 2053, and

(B) a waiver of the right to have such amount allowed at any time as a deduction under section 2053.

(e) DEFINITIONS.—For purposes of this section—

(1) The term "medical care" means 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 (including amounts paid for accident or health insurance), or

(B) for transportation primarily for and essential to medical care referred to in subparagraph (A).

(2) The determination of whether an individual is married at any time during the taxable year shall be made in accordance with the provisions of section 6013 (d) (relating to determination of status as husband and wife).

(f) EXCLUSION OF AMOUNTS ALLOWED FOR CARE OF CERTAIN DEPENDENTS.—Any expense allowed as a deduction under section 214 shall not be treated as an expense paid for medical care.

SEC. 214. EXPENSES FOR CARE OF CERTAIN DEPENDENTS

(a) GENERAL RULE.—There shall be allowed as a deduction expenses paid during the taxable year by a taxpayer who is a woman or a widower for the care of one or more dependents (as defined in subsection (c) (1)), but only if such care is for the purpose of enabling the taxpayer to be gainfully employed.

(b) LIMITATIONS.—

(1) IN GENERAL.—The deduction under subsection (a)—

(A) shall not exceed $600 for any taxable year; and

(B) shall not apply to any amount paid to an individual with respect to whom the taxpayer is allowed for his taxable year a deduction under section 151 (relating to deductions for personal exemptions).

(2) WORKING WIVES.—In the case of a woman who is married, the deduction under subsection (a)—

(A) shall not be allowed unless she files a joint return with her husband for the taxable year, and

(B) shall be reduced by the amount (if any) by which the adjusted gross income of the taxpayer and her spouse exceeds $4,500.

This paragraph shall not apply if the taxpayer's husband is incapable of self-support because mentally or physically defective.

(c) DEFINITIONS.—For purposes of this section—

(1) DEPENDENT.—The term "dependent" means a person with respect to whom the taxpayer is entitled to an exemption under section 151 (e) (1)—

(A) who has not attained the age of 12 years and who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer; or

(B) who is physically or mentally incapable of caring for himself.

(2) WIDOWER.—The term "widower" includes an unmarried individual who is legally separated from his spouse under a decree of divorce or of separate maintenance.

(3) DETERMINATION OF STATUS.—A woman shall not be considered as married if she is legally separated from her spouse under a decree of divorce or of separate maintenance at the close of the taxable year.

SEC. 215. ALIMONY, ETC., PAYMENTS.

(a) GENERAL RULE.—In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. No deduction shall be allowed under the preceding sentence with respect to any payment if, by reason of section 71 (d) or 682, the amount thereof is not includible in the husband's gross income.

(b) CROSS REFERENCE.—

For definitions of "husband" and "wife", see section 7701 (a) (17).

SEC. 216. AMOUNTS REPRESENTING TAXES AND INTEREST PAID TO COOPERATIVE HOUSING CORPORATION.

(a) ALLOWANCE OF DEDUCTION.—In the case of a tenant-stockholder (as defined in subsection (b) (2)), there shall be allowed as a deduction amounts (not otherwise deductible) paid or accrued to a cooperative housing corporation within the taxable year, but only to the extent that such amounts represent the tenant-stockholder's proportionate share of—

(1) the real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation on the houses or apartment building and on the land on which such houses (or building) are situated, or

(2) the interest allowable as a deduction to the corporation under section 163 which is paid or incurred by the corporation on its indebtedness contracted—

(A) in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses or apartment building, or

(B) in the acquisition of the land on which the houses (or apartment building) are situated.

(b) DEFINITIONS.—For purposes of this section—

(1) COOPERATIVE HOUSING CORPORATION.—The term "cooperative housing corporation" means a corporation—

(A) having one and only one class of stock outstanding,

(B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

(2) TENANT-STOCKHOLDER.—The term "tenant-stockholder" means an individual who is a stockholder in a cooperative housing corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary or his delegate as bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which situated which is attributable to the house or apartment which such individual is entitled to occupy.

(3) The term "tenant-stockholder's proportionate share" means that proportion which the stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation (including any stock held by the corporation).

SEC. 217. CROSS REFERENCES.

(1) For deduction for long-term capital gains in the case of a taxpayer other than a corporation, see section 1202.

(2) For deductions in respect of a decedent, see section 691.

PART VIII—SPECIAL DEDUCTIONS FOR CORPORATIONS

Sec. 241. Allowance of special deductions.
Sec. 242. Partially tax-exempt interest.
Sec. 243. Dividends received by corporations.
Sec. 244. Dividends received on certain preferred stock.
Sec. 245. Dividends received from certain foreign corporations.
Sec. 246. Rules applying to deductions for dividends received.
Sec. 247. Dividends paid on certain preferred stock of public utilities.
Sec. 248. Organizational expenditures.

SEC. 241. ALLOWANCE OF SPECIAL DEDUCTIONS.

In addition to the deductions provided in part VI (sec. 161 and following), there shall be allowed as deductions in computing taxable income the items specified in this part.

SEC. 242. PARTIALLY TAX-EXEMPT INTEREST.

(a) ALLOWANCE OF DEDUCTION.—There shall be allowed to a corporation as a deduction the amount received as interest on obligations

of the United States or on obligations of corporations organized under Act of Congress which are instrumentalities of the United States, but only if—

(1) such interest is included in gross income; and

(2) such interest is exempt from normal tax under the Act authorizing the issuance of such obligations.

(b) CROSS REFERENCE.—

For reduction of deduction under subsection (a) on account of amortizable bond premium, see section 171.

SEC. 243. DIVIDENDS RECEIVED BY CORPORATIONS.

(a) GENERAL RULE.—In the case of a corporation, there shall be allowed as a deduction an amount equal to 85 percent of the amount received as dividends (other than dividends described in paragraph (1) of section 244, relating to dividends on the preferred stock of a public utility) from a domestic corporation which is subject to taxation under this chapter.

(b) SPECIAL RULES FOR CERTAIN DISTRIBUTIONS.—For purposes of subsection (a)—

(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

(2) A dividend received from a regulated investment company shall be subject to the limitations prescribed in section 854.

SEC. 244. DIVIDENDS RECEIVED ON CERTAIN PREFERRED STOCK.

In the case of a corporation, there shall be allowed as a deduction an amount computed as follows:

(1) First determine the amount received as dividends on the preferred stock of a public utility which is subject to taxation under this chapter and with respect to which the deduction provided in section 247 for dividends paid is allowable.

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) the numerator of which is 14 percent, and

(B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

(3) Finally ascertain the amount which is 85 percent of the excess of—

(A) the amount determined under paragraph (1), over

(B) the amount determined under paragraph (2).

SEC. 245. DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.

In the case of dividends received from a foreign corporation (other than a foreign personal holding company) which is subject to taxation under this chapter, if, for an uninterrupted period of not less than 36 months ending with the close of such foreign corporation's taxable year in which such dividends are paid (or, if the corporation has not been in existence for 36 months at the close of such taxable year, for the period the foreign corporation has been in existence as of the close of such taxable year) such foreign corporation has been

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engaged in trade or business within the United States and has derived 50 percent or more of its gross income from sources within the United States, there shall be allowed as a deduction in the case of a corporation—

(1) An amount equal to the percent (specified in section 243 for the taxable year) of the dividends received out of its earnings and profits specified in paragraph (2) of the first sentence of section 316 (a), but such amount shall not exceed an amount which bears the same ratio to such percent of such dividends received out of such earnings and profits as the gross income of such foreign corporation for the taxable year from sources within the United States bears to its gross income from all sources for such taxable year, and

(2) An amount equal to the percent (specified in section 243 for the taxable year) of the dividends received out of that part of its earnings and profits specified in paragraph (1) of the first sentence of section 316 (a) accumulated after the beginning of such uninterrupted period, but such amount shall not exceed an amount which bears the same ratio to such percent of such dividends received out of such accumulated earnings and profits as the gross income of such foreign corporation from sources within the United States for the portion of such uninterrupted period ending at the beginning of such taxable year bears to its gross income from all sources for such portion of such uninterrupted period.

SEC. 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

(a) DEDUCTION NOT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

(1) a corporation organized under the China Trade Act, 1922 (see sec. 941); or

(2) a corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is—

(A) a corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or

(B) a corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

(b) LIMITATION ON AGGREGATE AMOUNT OF DEDUCTIONS.—

(1) GENERAL RULE.—Except as provided in paragraph (2), the aggregate amount of the deductions allowed by sections 243, 244, and 245 shall not exceed 85 percent of the taxable income computed without regard to the deductions allowed by sections 172, 243, 244, 245, and 247.

(2) EFFECT OF NET OPERATING LOSS.—Paragraph (1) shall not apply for any taxable year for which there is a net operating loss (as determined under section 172).

SEC. 247. DIVIDENDS PAID ON CERTAIN PREFERRED STOCK OF PUBLIC UTILITIES.

(a) AMOUNT OF DEDUCTION.—In the case of a public utility, there shall be allowed as a deduction an amount computed as follows:

(1) First determine the amount which is the lesser of—

(A) the amount of dividends paid during the taxable year on its preferred stock, or

(B) the taxable income for the taxable year (computed without the deduction allowed by this section).

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) the numerator of which is 14 percent, and

(B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year specified in section 11.

For purposes of the deduction provided in this section, the amount of dividends paid shall not include any amount distributed in the current taxable year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. Amounts distributed in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year shall for purposes of this subsection be deemed to be distributed with respect to the earliest year or years for which there are dividends unpaid and accumulated.

(b) DEFINITIONS.—For purposes of this section and section 244—

(1) PUBLIC UTILITY.—The term "public utility" means a corporation engaged in the furnishing of telephone service or in the sale of electrical energy, gas, or water, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof.

(2) PREFERRED STOCK.—The term "preferred stock" means stock issued before October 1, 1942, which during the whole of the taxable year (or the part of the taxable year after its issue) was stock the dividends in respect of which were cumulative, limited to the same amount, and payable in preference to the payment of dividends on other stock. Stock issued on or after October 1, 1942, shall be deemed for purposes of this paragraph to have been issued before October 1, 1942, if it was issued (including issuance either by the same or another corporation in a transaction which is a reorganization (as defined in section 368 (a)), a transaction to which section 371 (relating to insolvency reorganizations) applies, or a transaction subject to part VI of subchapter O (relating to exchanges in SEC obedience orders), or the respectively corresponding provisions of the Internal Revenue Code of 1939) to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock (including stock which is preferred stock by reason of this sentence), but only to the extent that the par or stated value of the new stock does not exceed the par, stated, or face value of the bonds or debentures issued before October 1, 1942, or the other preferred stock, which such new stock is issued to refund

or replace. The determination of whether stock was issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, shall be made under regulations prescribed by the Secretary or his delegate.

SEC. 248. ORGANIZATIONAL EXPENDITURES.

(a) ELECTION TO AMORTIZE.—The organizational expenditures of a corporation may, at the election of the corporation (made in accordance with regulations prescribed by the Secretary or his delegate), be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the corporation (beginning with the month in which the corporation begins business).

(b) ORGANIZATIONAL EXPENDITURES DEFINED.—The term "organizational expenditures" means any expenditure which—

(1) is incident to the creation of the corporation;

(2) is chargeable to capital account; and

(3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

(c) TIME FOR AND SCOPE OF ELECTION.—The election provided by subsection (a) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The period so elected shall be adhered to in computing the taxable income of the corporation for the taxable year for which the election is made and all subsequent taxable years. The election shall apply only with respect to expenditures paid or incurred on or after the date of enactment of this title.

PART IX—ITEMS NOT DEDUCTIBLE

Sec. 261. General rule for disallowance of deductions.
Sec. 262. Personal, living, and family expenses.
Sec. 263. Capital expenditures.
Sec. 264. Certain amounts paid in connection with insurance contracts.
Sec. 265. Expenses and interest relating to tax-exempt income.
Sec. 266. Carrying charges.
Sec. 267. Losses, expenses, and interest with respect to transactions between related taxpayers.
Sec. 268. Sale of land with unharvested crop.
Sec. 269. Acquisitions made to evade or avoid income tax.
Sec. 270. Limitation on deductions allowable to individuals in certain cases.
Sec. 271. Debts owed by political parties, etc.
Sec. 272. Disposal of coal.
Sec. 273. Holders of life or terminable interest.

SEC. 261. GENERAL RULE FOR DISALLOWANCE OF DEDUCTIONS.

In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part.

SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

SEC. 263. CAPITAL EXPENDITURES.

(a) GENERAL RULE.—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174, or

(C) soil and water conservation expenditures deductible under section 175.

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

(b) EXPENDITURES FOR ADVERTISING AND GOOD WILL.—If a corporation has, for the purpose of computing its excess profits tax credit under chapter 2E or subchapter D of chapter 1 of the Internal Revenue Code of 1939 claimed the benefits of the election provided in section 733 or section 451 of such code, as the case may be, no deduction shall be allowable under section 162 to such corporation for expenditures for advertising or the promotion of good will which, under the rules and regulations prescribed under section 733 or section 451 of such code, as the case may be, may be regarded as capital investments.

(c) INTANGIBLE DRILLING AND DEVELOPMENT COSTS IN THE CASE OF OIL AND GAS WELLS.—Notwithstanding subsection (a), regulations shall be prescribed by the Secretary or his delegate under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress.

SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

(a) GENERAL RULE.—No deduction shall be allowed for—

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

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

(b) CONTRACTS TREATED AS SINGLE PREMIUM CONTRACTS.—For purposes of subsection (a) (2), a contract shall be treated as a single premium contract—

(1) if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or

(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

SEC. 265. EXPENSES AND INTEREST RELATING TO TAX-EXEMPT INCOME.

No deduction shall be allowed for—

(1) EXPENSES.—Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

(2) INTEREST.—Interest on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest on which is wholly exempt from the taxes imposed by this subtitle.

SEC. 266. CARRYING CHARGES.

No deduction shall be allowed for amounts paid or accrued for such taxes and carrying charges as, under regulations prescribed by the Secretary or his 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.

SEC. 267. LOSSES, EXPENSES, AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS.

(a) DEDUCTIONS DISALLOWED.—No deduction shall be allowed—

(1) LOSSES.—In respect of losses from sales or exchanges of property (other than losses in cases of distributions in corporate liquidations), directly or indirectly, between persons specified within any one of the paragraphs of subsection (b).

(2) UNPAID EXPENSES AND INTEREST.—In respect of expenses, otherwise deductible under section 162 or 212, or of interest, otherwise deductible under section 163,—

(A) If within the period consisting of the taxable year of the taxpayer and 2½ months after the close thereof (i) such expenses or interest are not paid, and (ii) the amount thereof is not includible in the gross income of the person to whom the payment is to be made; and

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

(C) If, at the close of the taxable year of the taxpayer or at any time within 2½ months thereafter, both the taxpayer and the person to whom the payment is to be made are persons specified within any one of the paragraphs of subsection (b).

(b) RELATIONSHIPS.—The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c) (4);

(2) 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;

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

(4) A grantor and a fiduciary of any trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; or

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual.

(c) CONSTRUCTIVE OWNERSHIP OF STOCK.—For purposes of determining, in applying subsection (b), the ownership of stock—

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

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

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

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

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

(d) AMOUNT OF GAIN WHERE LOSS PREVIOUSLY DISALLOWED.—If—

(1) in the case of a sale or exchange of property to the taxpayer a loss sustained by the transferor is not allowable to the transferor as a deduction by reason of subsection (a) (1) (or by reason of section 24 (b) of the Internal Revenue Code of 1939); and

(2) after December 31, 1953, the taxpayer sells or otherwise disposes of such property (or of other property the basis of which in his hands is determined directly or indirectly by reference to such property) at a gain,

then such gain shall be recognized only to the extent that it exceeds so much of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer. This subsection applies with respect to taxable years ending after December 31, 1953. This subsection shall not apply if the loss sustained by the transferor is not allowable to the transferor as a deduction by reason of section 1091 (relating to wash sales) or by reason of section 118 of the Internal Revenue Code of 1939.

SEC. 268. SALE OF LAND WITH UNHARVESTED CROP.

Where an unharvested crop sold by the taxpayer is considered under the provisions of section 1231 as "property used in the trade or business", in computing taxable income no deduction (whether or not for the taxable year of the sale and whether for expenses, depreciation, or otherwise) attributable to the production of such crop shall be allowed.

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

(a) IN GENERAL.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor 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 which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) POWER OF SECRETARY OR HIS DELEGATE TO ALLOW DEDUCTION, ETC., IN PART.—In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

(c) PRESUMPTION IN CASE OF DISPROPORTIONATE PURCHASE PRICE.—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and

(2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,

shall be prima facie evidence of the principal purpose of evasion or avoidance of Federal income tax. This subsection shall apply only with respect to acquisitions after March 1, 1954.

SEC. 270. LIMITATION ON DEDUCTIONS ALLOWABLE TO INDIVIDUALS IN CERTAIN CASES.

(a) RECOMPUTATION OF TAXABLE INCOME.—If the deductions allowed by this chapter or the corresponding provisions of prior revenue laws (other than specially treated deductions, as defined in subsection (b)) allowable to an individual (except for the provisions of this section or the corresponding provisions of prior revenue laws) and attributable to a trade or business carried on by him for 5 consecutive taxable years have, in each of such years (including at least one year to which this subtitle applies), exceeded by more than $50,000 the gross income derived from such trade or business, the taxable income (computed under section 63 or the corresponding provisions of prior revenue laws) of such individual for each of such years shall be recomputed. For the purpose of such recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of $50,000 plus the gross income attributable to such trade or business, except that the net operating loss deduction, to the extent attributable to such trade or business, shall not be allowed.

(b) SPECIALLY TREATED DEDUCTIONS.—For the purpose of subsection (a) the specially treated deductions shall be taxes, interest, casualty and abandonment losses connected with a trade or business deductible under section 165 (c) (1), losses and expenses of the trade or business of farming which are directly attributable to drought, the net operating loss deduction allowed by section 172, and expenditures as to which taxpayers are given the option, under law or regulations, either (1) to deduct as expenses when incurred or (2) to defer or capitalize.

(c) REDETERMINATION OF TAX.—On the basis of the taxable income computed under the provisions of subsection (a) for each of the 5 consecutive taxable years specified in such subsection, the tax imposed by this subtitle or the corresponding provisions of prior revenue laws shall be redetermined for each such taxable year. If for any such taxable year assessment of a deficiency is prevented (except for the provisions of section 1311 and following) by the operation of any law or rule of law (other than section 7122, relating to compromises), any increase in the tax previously determined for such taxable year shall be considered a deficiency for purposes of this section. For purposes of this section, the term "tax previously determined" shall have the meaning assigned to such term by section 1314 (a) (1).

(d) EXTENSION OF STATUTE OF LIMITATIONS.—Notwithstanding any law or rule of law (other than section 7122, relating to compromises), any amount determined as a deficiency under subsection (c), or which would be so determined if assessment were prevented in the manner described in subsection (c), with respect to any taxable year may be assessed as if on the date of the expiration of the time prescribed by law for the assessment of a deficiency for the fifth taxable year of the 5 consecutive taxable years specified in subsection (a), 1 year remained before the expiration of the period of limitation upon assessment for any such taxable year.

SEC. 271. DEBTS OWED BY POLITICAL PARTIES, ETC.

(a) GENERAL RULE.—In the case of a taxpayer (other than a bank as defined in section 581) no deduction shall be allowed under section 166 (relating to bad debts) or under section 165 (g) (relating to worthlessness of securities) by reason of the worthlessness of any debt owed by a political party.

(b) DEFINITIONS.—

(1) POLITICAL PARTY.—For purposes of subsection (a), the term "political party" means—

(A) a political party;

(B) a national, State, or local committee of a political party; or

(C) a committee, association, or organization which accepts contributions or makes expenditures for the purpose of influencing or attempting to influence the election of presidential or vice-presidential electors or of any individual whose name is presented for election to any Federal, State, or local elective public office, whether or not such individual is elected.

(2) CONTRIBUTIONS.—For purposes of paragraph (1) (C), the term "contributions" includes a gift, subscription, loan, advance, or deposit, of money, or anything of value, and includes a contract, promise, or agreement to make a contribution, whether or not legally enforceable.

(3) EXPENDITURES.—For purposes of paragraph (1) (C), the term "expenditures" includes a payment, distribution, loan, advance, deposit, or gift, of money, or anything of value, and includes a contract, promise, or agreement to make an expenditure, whether or not legally enforceable.

SEC. 272. DISPOSAL OF COAL.

Where the disposal of coal is covered by section 631, no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract, except that if in any taxable year such expenditures plus the adjusted depletion basis of the coal disposed of in such taxable year exceed the amount realized under such contract, such excess, to the extent not availed of as a reduction of gain under section 1231, shall be a loss deductible under section 165 (a). This section shall not apply to any taxable year during which there is no income under the contract.

SEC. 273. HOLDERS OF LIFE OR TERMINABLE INTEREST.

Amounts paid under the laws of a State, a Territory, the District of Columbia, a possession of the United States, or a foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time.

Subchapter C—Corporate Distributions and Adjustments

Part I. Distributions by corporations.
Part II. Corporate liquidations.
Part III. Corporate organizations and reorganizations.
Part IV. Insolvency reorganizations.
Part V. Carryovers.
Part VI. Effective date of subchapter C.

PART I—DISTRIBUTIONS BY CORPORATIONS

Subpart A. Effects on recipients.
Subpart B. Effects on corporation.
Subpart C. Definitions; constructive ownership of stock.

Subpart A—Effects on Recipients

Sec. 301. Distributions of property.
Sec. 302. Distributions in redemption of stock.
Sec. 303. Distributions in redemption of stock to pay death taxes.
Sec. 304. Redemption through use of related corporations.
Sec. 305. Distributions of stock and stock rights.
Sec. 306. Dispositions of certain stock.
Sec. 307. Basis of stock and stock rights acquired in distributions.

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) AMOUNT DISTRIBUTED.—

(1) GENERAL RULE.—For purposes of this section, the amount of any distribution shall be—

(A) NONCORPORATE DISTRIBUTEES.—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) CORPORATE DISTRIBUTEES.—If the shareholder is a corporation, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311.

(2) REDUCTION FOR LIABILITIES.—The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) DETERMINATION OF FAIR MARKET VALUE.—For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) AMOUNT TAXABLE.—In the case of a distribution to which subsection (a) applies—

(1) AMOUNT CONSTITUTING DIVIDEND.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) AMOUNT APPLIED AGAINST BASIS.—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) AMOUNT IN EXCESS OF BASIS.—

(A) IN GENERAL.—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) DISTRIBUTIONS OUT OF INCREASE IN VALUE ACCRUED BEFORE MARCH 1, 1913.—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

(d) BASIS.—The basis of property received in a distribution to which subsection (a) applies shall be—

(1) NONCORPORATE DISTRIBUTEES.—If the shareholder is not a corporation, the fair market value of such property.

(2) CORPORATE DISTRIBUTEES.—If the shareholder is a corporation, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311.

(e) EXCEPTION FOR CERTAIN DISTRIBUTIONS BY PERSONAL SERVICE CORPORATIONS.—Any distribution made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or the Revenue Act of 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 (40 Stat. 1070), or section 218 of the Revenue Act of 1921 (42 Stat. 245), shall be exempt from tax to the distributees.

(f) SPECIAL RULES.—

(1) For distributions in redemption of stock, see section 302.

(2) For distributions in partial or complete liquidation, see part II (sec. 331 and following).

(3) For distributions in corporate organizations and reorganizations, see part III (sec. 351 and following).

(4) For partial exclusion from gross income of dividends received by individuals, see section 116.

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) GENERAL RULE.—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) REDEMPTIONS TREATED AS EXCHANGES.—

(1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) SUBSTANTIALLY DISPROPORTIONATE REDEMPTION OF STOCK.—

(A) IN GENERAL.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) LIMITATION.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) DEFINITIONS.—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) SERIES OF REDEMPTIONS.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) TERMINATION OF SHAREHOLDER'S INTEREST.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) STOCK ISSUED BY RAILROAD CORPORATIONS IN CERTAIN REORGANIZATIONS.—Subsection (a) shall apply if the redemption is of stock issued by a railroad corporation (as defined in section 77 (m) of the Bankruptcy Act, as amended) pursuant to a plan of reorganization under section 77 of the Bankruptcy Act.

(5) APPLICATION OF PARAGRAPHS.—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c) (2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

(c) CONSTRUCTIVE OWNERSHIP OF STOCK.—

(1) IN GENERAL.—Except as provided in paragraph (2) of this subsection, section 318 (a) shall apply in determining the ownership of stock for purposes of this section.

(2) FOR DETERMINING TERMINATION OF INTEREST.—

(A) In the case of a distribution described in subsection (b)(3), section 318 (a) (1) shall not apply if—

(i) 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,

(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 his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

If the distributee acquires such an interest in the corporation (other than by bequest or inheritance) within 10 years from the date of the distribution, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting from such acquisition, include one year immediately following the date on which the distributee (in accordance with regulations prescribed by the Secretary or his delegate) notifies the Secretary or his delegate of such acquisition; and such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318 (a), or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318 (a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

(d) REDEMPTIONS TREATED AS DISTRIBUTIONS OF PROPERTY.—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317 (b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

(e) CROSS REFERENCES.—

For special rules relating to redemption—

(1) Death Taxes.—Of stock to pay death taxes, see section 303.

(2) Section 306 Stock.—Of section 306 stock, see section 306.

(3) Liquidations.—Of stock in partial or complete liquidation, see section 331.

SEC. 303. DISTRIBUTIONS IN REDEMPTION OF STOCK TO PAY DEATH TAXES.

(a) IN GENERAL.—A distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation which (for Federal estate tax purposes) is included in determining the gross estate of a decedent, to the extent that the amount of such distribution does not exceed the sum of—

(1) the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death, and

(2) the amount of funeral and administration expenses allowable as deductions to the estate under section 2053 (or under section 2106 in the case of the estate of a decedent nonresident, not a citizen of the United States),

shall be treated as a distribution in full payment in exchange for the stock so redeemed.

(b) LIMITATIONS ON APPLICATION OF SUBSECTION (a).—

(1) PERIOD FOR DISTRIBUTION.—Subsection (a) shall apply only to amounts distributed after the death of the decedent and—

(A) within the period of limitations provided in section 6501 (a) for the assessment of the Federal estate tax (determined without the application of any provision other than section 6501 (a)), or within 90 days after the expiration of such period, or

(B) if a petition for redetermination of a deficiency in such estate tax has been filed with the Tax Court within the time prescribed in section 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final.

(2) RELATIONSHIP OF STOCK TO DECEDENT'S ESTATE.—

(A) IN GENERAL.—Subsection (a) shall apply to a distribution by a corporation only if the value (for Federal estate tax purposes) of all of the stock of such corporation which is included in determining the value of the decedent's gross estate is either—

(i) more than 35 percent of the value of the gross estate of such decedent, or

(ii) more than 50 percent of the taxable estate of such decedent.

(B) SPECIAL RULE FOR STOCK OF TWO OR MORE CORPORATIONS.—For purposes of the 35 percent and 50 percent requirements of subparagraph (A), stock of two or more corporations, with respect to each of which there is included in determining the value of the decedent's gross estate more than 75 percent in value of the outstanding stock, shall be treated as the stock of a single corporation. For the purpose of the 75 percent requirement of the preceding sentence, stock which, at the decedent's death, represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property shall

be treated as having been included in determining the value of the decedent's gross estate.

(c) STOCK WITH SUBSTITUTED BASIS.—If—

(1) a shareholder owns stock of a corporation (referred to in this subsection as "new stock") the basis of which is determined by reference to the basis of stock of a corporation (referred to in this subsection as "old stock"),

(2) the old stock was included (for Federal estate tax purposes) in determining the gross estate of a decedent, and

(3) subsection (a) would apply to a distribution of property to such shareholder in redemption of the old stock,

then, subject to the limitation specified in subsection (b) (1), subsection (a) shall apply in respect of a distribution in redemption of the new stock.

SEC. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS.

(a) TREATMENT OF CERTAIN STOCK PURCHASES.—

(1) ACQUISITION BY RELATED CORPORATION (OTHER THAN SUBSIDIARY).—For purposes of sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

(2) ACQUISITION BY SUBSIDIARY.—For purposes of sections 302 and 303, if—

(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and

(B) the issuing corporation controls the acquiring corporation,

then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

(b) SPECIAL RULES FOR APPLICATION OF SUBSECTION (a).—

(1) RULE FOR DETERMINATIONS UNDER SECTION 302 (b).—In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302 (b), to be treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation. In applying section 318 (a) (relating to constructive ownership of stock) with respect to section 302 (b) for purposes of this paragraph, section 318 (a) (2) (C) shall be applied without regard to the 50 percent limitation contained therein.

(2) AMOUNT CONSTITUTING DIVIDEND.—

(A) WHERE SUBSECTION (a) (1) APPLIES.—In the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) of this section applies, the determination of

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the amount which is a dividend shall be made solely by reference to the earnings and profits of the acquiring corporation.

(B) WHERE SUBSECTION (a) (2) APPLIES.—In the case of any acquisition of stock to which subsection (a) (2) of this section applies, the determination of the amount which is a dividend shall be made as if the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation.

(c) CONTROL.—

(1) IN GENERAL.—For purposes of this section, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) shall be treated as in control of such other corporation.

(2) CONSTRUCTIVE OWNERSHIP.—Section 318 (a) (relating to the constructive ownership of stock) shall apply for purposes of determining control under paragraph (1). For purposes of the preceding sentence, section 318 (a) (2) (C) shall be applied without regard to the 50 percent limitation contained therein.

SEC. 305. DISTRIBUTIONS OF STOCK AND STOCK RIGHTS.

(a) GENERAL RULE.—Except as provided in subsection (b), gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock or in rights to acquire its stock.

(b) DISTRIBUTIONS IN LIEU OF MONEY.—Subsection (a) shall not apply to a distribution by a corporation of its stock (or rights to acquire its stock), and the distribution shall be treated as a distribution of property to which section 301 applies—

(1) to the extent that the distribution is made in discharge of preference dividends for the taxable year of the corporation in which the distribution is made or for the preceding taxable year; or

(2) 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 in rights to acquire its stock), or

(B) in property.

(c) CROSS REFERENCES.—

For special rules—

(1) Relating to the receipt of stock and stock rights in corporate organizations and reorganizations, see part III (sec. 351 and following).

(2) In the case of a distribution which results in a gift, see section 2501 and following.

(3) In the case of a distribution which has the effect of the payment of compensation, see section 61 (a) (1).

SEC. 306. DISPOSITIONS OF CERTAIN STOCK.

(a) GENERAL RULE.—If a shareholder sells or otherwise disposes of section 306 stock (as defined in subsection (c))—

(1) DISPOSITIONS OTHER THAN REDEMPTIONS.—If such disposition is not a redemption (within the meaning of section 317 (b))—

(A) The amount realized shall be treated as gain from the sale of property which is not a capital asset. This subparagraph shall not apply to the extent that—

(i) the amount realized, exceeds

(ii) such stock's ratable share of the amount which 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.

(B) Any excess of the amount realized over the sum of—

(i) the amount treated under subparagraph (A) as gain from the sale of property which is not a capital asset, plus

(ii) the adjusted basis of the stock,

shall be treated as gain from the sale of such stock.

(C) No loss shall be recognized.

(2) REDEMPTION.—If the disposition is a redemption, the amount realized shall be treated as a distribution of property to which section 301 applies.

(b) EXCEPTIONS.—Subsection (a) shall not apply—

(1) TERMINATION OF SHAREHOLDER'S INTEREST.—

(A) NOT IN REDEMPTION.—If the disposition—

(i) is not a redemption;

(ii) is not, directly or indirectly, to a person the ownership of whose stock would (under section 318 (a)) be attributable to the shareholder; and

(iii) terminates the entire stock interest of the shareholder in the corporation (and for purposes of this clause, section 318 (a) shall apply).

(B) IN REDEMPTION.—If the disposition is a redemption and section 302 (b) (3) applies.

(2) LIQUIDATIONS.—If the section 306 stock is redeemed in a distribution in partial or complete liquidation to which part II (sec. 331 and following) applies.

(3) WHERE GAIN OR LOSS IS NOT RECOGNIZED.—To the extent that, under any provision of this subtitle, gain or loss to the shareholder is not recognized with respect to the disposition of the section 306 stock.

(4) TRANSACTIONS NOT IN AVOIDANCE.—If it is established to the satisfaction of the Secretary or his delegate—

(A) that the distribution, and the disposition or redemption, or

(B) in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, that the disposition (or redemption) of the section 306 stock,

was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(c) SECTION 306 STOCK DEFINED.—

(1) IN GENERAL.—For purposes of this subchapter, the term "section 306 stock" means stock which meets the requirements of subparagraph (A), (B), or (C) of this paragraph.

(A) DISTRIBUTED TO SELLER.—Stock (other than common stock issued with respect to common stock) which was distributed to the shareholder selling or otherwise disposing of such stock if, by reason of section 305 (a), any part of such distribution was not includible in the gross income of the shareholder.

(B) RECEIVED IN A CORPORATE REORGANIZATION OR SEPARATION.—Stock which is not common stock and—

(i) 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)), or in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applied, 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.

For purposes of this section, a receipt of stock to which the foregoing provisions of this subparagraph apply shall be treated as a distribution of stock.

(C) STOCK HAVING TRANSFERRED OR SUBSTITUTED BASIS.—Except as otherwise provided in subparagraph (B), stock the basis of which (in the hands of the shareholder selling or otherwise disposing of such stock) is determined by reference to the basis (in the hands of such shareholder or any other person) of section 306 stock.

(2) EXCEPTION WHERE NO EARNINGS AND PROFITS.—For purposes of this section, the term "section 306 stock" does not include any stock no part of the distribution of which would have been a dividend at the time of the distribution if money had been distributed in lieu of the stock.

(d) STOCK RIGHTS.—For purposes of this section—

(1) stock rights shall be treated as stock, and

(2) stock acquired through the exercise of stock rights shall be treated as stock distributed at the time of the distribution of the stock rights, to the extent of the fair market value of such rights at the time of the distribution.

(e) CONVERTIBLE STOCK.—For purposes of subsection (c)—

(1) if section 306 stock was issued with respect to common stock and later such section 306 stock is exchanged for common stock in the same corporation (whether or not such exchange is pursuant to a conversion privilege contained in the section 306 stock), then (except as provided in paragraph (2)) the common stock so received shall not be treated as section 306 stock; and

(2) common stock with respect to which there is a privilege of converting into stock other than common stock (or into property), whether or not the conversion privilege is contained in such stock, shall not be treated as common stock.

(f) SOURCE OF GAIN.—The amount treated under subsection (a) (1) (A) as gain from the sale of property which is not a capital asset shall, for purposes of part I of subchapter N (sec. 861 and following, relating

to determination of sources of income), be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock. If under the preceding sentence such amount is determined to be derived from sources within the United States, such amount shall be considered to be fixed or determinable annual or periodical gains, profits, and income within the meaning of section 871 (a) or section 881 (a), as the case may be.

(g) CHANGE IN TERMS AND CONDITIONS OF STOCK.—If a substantial change is made in the terms and conditions of any stock, then, for purposes of this section—

(1) the fair market value of such stock shall be the fair market value at the time of the distribution or at the time of such change, whichever such value is higher;

(2) such stock's ratable share of the amount which would have been a dividend if money had been distributed in lieu of stock shall be determined as of the time of distribution or as of the time of such change, whichever such ratable share is higher; and

(3) subsection (c) (2) shall not apply unless the stock meets the requirements of such subsection both at the time of such distribution and at the time of such change.

(h) STOCK RECEIVED IN DISTRIBUTIONS AND REORGANIZATIONS TO WHICH 1939 CODE APPLIED.—If stock—

(1) was received in a distribution or reorganization to which the Internal Revenue Code of 1939 (or the corresponding provisions of prior law) applied,

(2) such stock would have been section 306 stock if this Code applied to such distribution or reorganization, and

(3) such stock is disposed of or redeemed on or after June 22, 1954,

then the foregoing subsections of this section shall not apply in respect of such disposition or redemption. The extent to which such disposition or redemption shall be treated as a dividend shall be determined as if the Internal Revenue Code of 1939 (as modified by the provisions of this Code other than the foregoing subsections of this section) continued to apply in respect of such disposition or redemption.

SEC. 307. BASIS OF STOCK AND STOCK RIGHTS ACQUIRED IN DISTRIBUTIONS.

(a) GENERAL RULE.—If a shareholder in a corporation receives its stock or rights to acquire its stock (referred to in this subsection as "new stock") in a distribution to which section 305 (a) applies, then the basis of such new stock and of the stock with respect to which it is distributed (referred to in this section as "old stock"), respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock. Such allocation shall be made under regulations prescribed by the Secretary or his delegate.

(b) EXCEPTION FOR CERTAIN STOCK RIGHTS.—

(1) IN GENERAL.—If—

(A) a corporation distributes rights to acquire its stock to a shareholder in a distribution to which section 305 (a) applies, and

(B) the fair market value of such rights at the time of the distribution is less than 15 percent of the fair market value of the old stock at such time,

then subsection (a) shall not apply and the basis of such rights shall be zero, unless the taxpayer elects under paragraph (2) of this subsection to determine the basis of the old stock and of the stock rights under the method of allocation provided in subsection (a).

(2) ELECTION.—The election referred to in paragraph (1) shall be made in the return filed within the time prescribed by law (including extensions thereof) for the taxable year in which such rights were received. Such election shall be made in such manner as the Secretary or his delegate may by regulations prescribe, and shall be irrevocable when made.

(c) CROSS REFERENCE.—

For basis of stock and stock rights distributed before June 22, 1954, see section 1052.

Subpart B—Effects on Corporation

Sec. 311. Taxability of corporation on distribution.
Sec. 312. Effect on earnings and profits.

SEC. 311. TAXABILITY OF CORPORATION ON DISTRIBUTION.

(a) GENERAL RULE.—Except as provided in subsections (b) and (c) of this section and section 453 (d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of—

(1) its stock (or rights to acquire its stock), or

(2) property.

(b) LIFO INVENTORY.—

(1) RECOGNITION OF GAIN.—If a corporation inventorying goods under the method provided in section 472 (relating to last-in, first-out inventories) distributes inventory assets (as defined in paragraph (2) (A)), then the amount (if any) by which—

(A) the inventory amount (as defined in paragraph (2) (B)) of such assets under a method authorized by section 471 (relating to general rule for inventories), exceeds

(B) the inventory amount of such assets under the method provided in section 472,

shall be treated as gain to the corporation recognized from the sale of such inventory assets.

(2) DEFINITIONS.—For purposes of paragraph (1)—

(A) INVENTORY ASSETS.—The term "inventory assets" means stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year.

(B) INVENTORY AMOUNT.—The term "inventory amount" means, in the case of inventory assets distributed during a taxable year, the amount of such inventory assets determined as if the taxable year closed at the time of such distribution.

(3) METHOD OF DETERMINING INVENTORY AMOUNT.—For purposes of this subsection, the inventory amount of assets under a method authorized by section 471 shall be determined—

(A) if the corporation uses the retail method of valuing inventories under section 472, by using such method, or

(B) if subparagraph (A) does not apply, by using cost or market, whichever is lower.

(c) LIABILITY IN EXCESS OF BASIS.—If—

(1) a corporation distributes property to a shareholder with respect to its stock,

(2) such property is subject to a liability, or the shareholder assumes a liability of the corporation in connection with the distribution, and

(3) the amount of such liability exceeds the adjusted basis (in the hands of the distributing corporation) of such property,

then gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. In the case of a distribution of property subject to a liability which is not assumed by the shareholder, the amount of gain to be recognized under the preceding sentence shall not exceed the excess, if any, of the fair market value of such property over its adjusted basis.

SEC. 312. EFFECT ON EARNINGS AND PROFITS.

(a) GENERAL RULE.—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—

(1) the amount of money,

(2) the principal amount of the obligations of such corporation, and

(3) the adjusted basis of the other property,

so distributed.

(b) CERTAIN INVENTORY ASSETS.—

(1) IN GENERAL.—On the distribution by a corporation, with respect to its stock, of inventory assets (as defined in paragraph (2) (A)) the fair market value of which exceeds the adjusted basis thereof, the earnings and profits of the corporation—

(A) shall be increased by the amount of such excess; and

(B) shall be decreased by whichever of the following is the lesser:

(i) the fair market value of the inventory assets distributed, or

(ii) the earnings and profits (as increased under subparagraph (A)).

(2) DEFINITIONS.—

(A) INVENTORY ASSETS.—For purposes of paragraph (1), the term "inventory assets" means—

(i) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year;

(ii) property held by the corporation primarily for sale to customers in the ordinary course of its trade or business; and

(iii) unrealized receivables or fees, except receivables from sales or exchanges of assets other than assets described in this subparagraph.

(B) UNREALIZED RECEIVABLES OR FEES.—For purposes of subparagraph (A) (iii), the term "unrealized receivables or fees" means, to the extent not previously includible in income under the method of accounting used by the corporation, any rights (contractual or otherwise) to payment for—

(i) goods delivered, or to be delivered, to the extent that the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(ii) services rendered or to be rendered.

(c) ADJUSTMENTS FOR LIABILITIES, ETC.—In making the adjustments to the earnings and profits of a corporation under subsection (a) or (b), proper adjustment shall be made for—

(1) the amount of any liability to which the property distributed is subject,

(2) the amount of any liability of the corporation assumed by a shareholder in connection with the distribution, and

(3) any gain to the corporation recognized under subsection (b) or (c) of section 311.

(d) CERTAIN DISTRIBUTIONS OF STOCK AND SECURITIES.—

(1) IN GENERAL.—The distribution to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property, in a distribution to which this Code applies, shall not be considered a distribution of the earnings and profits of any corporation—

(A) if no gain to such distributee from the receipt of such stock or securities, or property, was recognized under this Code, or

(B) if the distribution was not subject to tax in the hands of such distributee by reason of section 305 (a).

(2) PRIOR DISTRIBUTIONS.—In the case of a distribution of stock or securities, or property, to which section 115 (h) of the Internal Revenue Code of 1939 (or the corresponding provision of prior law) applied, the effect on earnings and profits of such distribution shall be determined under such section 115 (h), or the corresponding provision of prior law, as the case may be.

(3) STOCK OR SECURITIES.—For purposes of this subsection, the term "stock or securities" includes rights to acquire stock or securities.

(e) SPECIAL RULE FOR PARTIAL LIQUIDATIONS AND CERTAIN REDEMPTIONS.—In the case of amounts distributed in partial liquidation (whether before, on, or after June 22, 1954) or in a redemption to which section 302 (a) or 303 applies, the part of such distribution which is properly chargeable to capital account shall not be treated as a distribution of earnings and profits.

(f) EFFECT ON EARNINGS AND PROFITS OF GAIN OR LOSS AND OF RECEIPT OF TAX-FREE DISTRIBUTIONS.—

(1) EFFECT ON EARNINGS AND PROFITS OF GAIN OR LOSS.—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(A) for the purpose of the computation of the earnings and profits of the corporation, shall (except as provided in subparagraph (B)) be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except

that no regard shall be had to the value of the property as of March 1, 1913; but

(B) for purposes of the computation of the earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing taxable income under the law applicable to the year in which such sale or disposition was made. Where, in determining the adjusted basis used in computing such realized gain or loss, the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings and profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For purposes of this subsection, a loss with respect to which a deduction is disallowed under section 1091 (relating to wash sales of stock or securities), or the corresponding provision of prior law, shall not be deemed to be recognized.

(2) EFFECT ON EARNINGS AND PROFITS OF RECEIPT OF TAX-FREE DISTRIBUTIONS.—Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(A) no such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made; and

(B) no such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received (or such basis would, but for section 307 (b), be so allocated).

(g) EARNINGS AND PROFITS—INCREASE IN VALUE ACCRUED BEFORE MARCH 1, 1913.—

(1) If any increase or decrease in the earnings and profits for any period beginning after February 28, 1913, with respect to any matter would be different had the adjusted basis of the property involved been determined without regard to its March 1, 1913, value, then, except as provided in paragraph (2), an increase (properly reflecting such difference) shall be made in that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913.

(2) If the application of subsection (f) to a sale or other disposition after February 28, 1913, results in a loss which is to be applied in decrease of earnings and profits for any period beginning after February 28, 1913, then, notwithstanding subsection (f) and in lieu of the rule provided in paragraph (1) of this subsection, the amount of such loss so to be applied shall be reduced by the amount,

if any, by which the adjusted basis of the property used in determining the loss exceeds the adjusted basis computed without regard to the value of the property on March 1, 1913, and if such amount so applied in reduction of the decrease exceeds such loss, the excess over such loss shall increase that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913.

(h) EARNINGS AND PROFITS OF PERSONAL SERVICE CORPORATIONS.—In the case of a personal service corporation subject for any taxable year to supplement S of the Internal Revenue Code of 1939, an amount equal to the undistributed supplement S net income of the personal service corporation for its taxable year shall be considered as paid in as of the close of such taxable year as paid-in surplus or as a contribution to capital, and the accumulated earnings and profits as of the close of such taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend in the gross income of the shareholders.

(i) ALLOCATION IN CERTAIN CORPORATE SEPARATIONS.—In the case of a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, proper allocation with respect to the earnings and profits of the distributing corporation and the controlled corporation (or corporations) shall be made under regulations prescribed by the Secretary or his delegate.

(j) DISTRIBUTION OF PROCEEDS OF LOAN INSURED BY THE UNITED STATES.—

(1) IN GENERAL.—If a corporation distributes property with respect to its stock, and if, at the time of the distribution—

(A) there is outstanding a loan to such corporation which was made, guaranteed, or insured by the United States (or by any agency or instrumentality thereof), and

(B) the amount of such loan so outstanding exceeds the adjusted basis of the property constituting security for such loan,

then the earnings and profits of the corporation shall be increased by the amount of such excess, and (immediately after the distribution) shall be decreased by the amount of such excess. For purposes of subparagraph (B) of the preceding sentence, the adjusted basis of the property at the time of distribution shall be determined without regard to any adjustment under section 1016 (a) (2) (relating to adjustment for depreciation, etc.). For purposes of this paragraph, a commitment to make, guarantee, or insure a loan shall be treated as the making, guaranteeing, or insuring of a loan.

(2) EFFECTIVE DATE.—Paragraph (1) shall apply only with respect to distributions made on or after June 22, 1954.

Subpart C—Definitions; Constructive Ownership of Stock

Sec. 316. Dividend defined.
Sec. 317. Other definitions.
Sec. 318. Constructive ownership of stock.

SEC. 316. DIVIDEND DEFINED.

(a) GENERAL RULE.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) SPECIAL RULES.—

(1) CERTAIN INSURANCE COMPANY DIVIDENDS.—The definition in subsection (a) shall not apply to the term "dividend" as used in sections 803 (e), 821 (a) (2), 823 (2), and 832 (c) (11) (where the reference is to dividends of insurance companies paid to policyholders).

(2) DISTRIBUTIONS BY PERSONAL HOLDING COMPANIES.—In the case of a corporation which—

(A) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(B) for the taxable year in respect of which the distribution is made under section 563 (b) (relating to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provisions of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

SEC. 317. OTHER DEFINITIONS.

(a) PROPERTY.—For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) REDEMPTION OF STOCK.—For purposes of this part, 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.

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) GENERAL RULE.—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) MEMBERS OF FAMILY.—

(A) IN GENERAL.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) his children, grandchildren, and parents.

(B) EFFECT OF ADOPTION.—For purposes of subparagraph (A) (ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

(2) PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.—

(A) PARTNERSHIPS AND ESTATES.—Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as being owned proportionately by its partners or beneficiaries. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as being owned by the partnership or estate.

(B) TRUSTS.—Stock owned, directly or indirectly, by or for a trust shall be considered as being owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust. Stock owned, directly or indirectly, by or for a beneficiary of a trust shall be considered as being owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of the preceding sentence, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property. Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as being owned by such person; and such trust shall be treated as owning the stock owned, directly or indirectly, by or for that person. This subparagraph shall not apply with respect to any employees' trust described in section 401 (a) which is exempt from tax under section 501 (a).

(C) CORPORATIONS.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then—

(i) such person shall be considered as owning the stock owned, directly or indirectly, by or for that corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation; and

(ii) such corporation shall be considered as owning the stock owned, directly or indirectly, by or for that person.

(3) OPTIONS.—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(4) CONSTRUCTIVE OWNERSHIP AS ACTUAL OWNERSHIP.—

(A) IN GENERAL.—Except as provided in subparagraph (B), stock constructively owned by a person by reason of the application of paragraph (1), (2), or (3) shall, for purposes of applying paragraph (1), (2), or (3), be treated as actually owned by such person.

(B) MEMBERS OF FAMILY.—Stock constructively owned by an individual by reason of the application of paragraph (1) shall not be treated as owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock.

(C) OPTION RULE IN LIEU OF FAMILY RULE.—For purposes of this paragraph, if stock may be considered as owned by an individual under paragraph (1) or (3), it shall be considered as owned by him under paragraph (3).

(b) CROSS REFERENCES.—

For provisions to which the rules contained in subsection (a) apply, see—

(1) section 302 (relating to redemption of stock);

(2) section 304 (relating to redemption by related corporations);

(3) section 306 (b) (1) (A) (relating to disposition of section 306 stock);

(4) section 334 (b) (3) (C) (relating to basis of property received in certain liquidations of subsidiaries); and

(5) section 382 (a) (3) (relating to special limitations on net operating loss carryovers).

PART II—CORPORATE LIQUIDATIONS

Subpart A. Effects on recipients.
Subpart B. Effects on corporation.
Subpart C. Collapsible corporations; foreign personal holding companies.
Subpart D. Definition.

Subpart A—Effects on Recipients

Sec. 331. Gain or loss to shareholder in corporate liquidations.
Sec. 332. Complete liquidations of subsidiaries.
Sec. 333. Election as to recognition of gain in certain liquidations.
Sec. 334. Basis of property received in liquidations.

SEC. 331. GAIN OR LOSS TO SHAREHOLDERS IN CORPORATE LIQUIDATIONS.

(a) GENERAL RULE.—

(1) COMPLETE LIQUIDATIONS.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

(2) PARTIAL LIQUIDATIONS.—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.

(b) NONAPPLICATION OF SECTION 301.—Section 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property in partial or complete liquidation.

(c) CROSS REFERENCES.—

(1) For general rule for determination of the amount of gain or loss to the distributee, see section 1001.

(2) For general rule for determination of the amount of gain or loss recognized, see section 1002.

SEC. 332. COMPLETE LIQUIDATIONS OF SUBSIDIARIES.

(a) GENERAL RULE.—No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

(b) LIQUIDATIONS TO WHICH SECTION APPLIES.—For purposes of subsection (a), a distribution shall be considered to be in complete liquidation only if—

(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends); and either

(2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(3) 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, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

If such transfer of all the property does not occur within the taxable year, the Secretary or his delegate may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such 3-year period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, the assessment and collection of all income taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this subsection shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for purposes

of this subsection a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (A) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, on an exchange described in section 361, and (B) the complete cancellation or redemption under the plan, as a result of exchanges described in section 354, of the shares not owned by the taxpayer.

(c) SPECIAL RULE FOR INDEBTEDNESS OF SUBSIDIARY TO PARENT.—If—

(1) a corporation is liquidated and subsection (a) applies to such liquidation, and

(2) on the date of the adoption of the plan of liquidation, such corporation was indebted to the corporation which meets the 80 percent stock ownership requirements specified in subsection (b),

then no gain or loss shall be recognized to the corporation so indebted because of the transfer of property in satisfaction of such indebtedness.

SEC. 333. ELECTION AS TO RECOGNITION OF GAIN IN CERTAIN LIQUIDATIONS.

(a) GENERAL RULE.—In the case of property distributed in complete liquidation of a domestic corporation (other than a collapsible corporation to which section 341 (a) applies), if—

(1) the liquidation is made in pursuance of a plan of liquidation adopted on or after June 22, 1954, and

(2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month,

then in the case of each qualified electing shareholder (as defined in subsection (c)) gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f).

(b) EXCLUDED CORPORATION.—For purposes of this section, the term "excluded corporation" means a corporation which at any time between January 1, 1954, and the date of the adoption of the plan of liquidation, both dates inclusive, was the owner of stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote on the adoption of such plan.

(c) QUALIFIED ELECTING SHAREHOLDERS.—For purposes of this section, the term "qualified electing shareholder" means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election to have the benefits of subsection (a) has been made and filed in accordance with subsection (d), but—

(1) in the case of a shareholder other than a corporation, only if written elections have been so filed by shareholders (other than corporations) who at the time of the adoption of the plan of liquidation are owners of stock possessing at least 80 percent of the total combined voting power (exclusive of voting power possessed by stock owned by corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation; or

(2) in the case of a shareholder which is a corporation, only if written elections have been so filed by corporate shareholders (other than an excluded corporation) which at the time of the adoption of such plan of liquidation are owners of stock possessing at least 80 percent of the total combined voting power (exclusive of voting power possessed by stock owned by an excluded corporation and by shareholders who are not corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation.

(d) MAKING AND FILING OF ELECTIONS.—The written elections referred to in subsection (c) must be made and filed in such manner as to be not in contravention of regulations prescribed by the Secretary or his delegate. The filing must be within 30 days after the date of the adoption of the plan of liquidation.

(e) NONCORPORATE SHAREHOLDERS.—In the case of a qualified electing shareholder other than a corporation—

(1) there shall be recognized, and treated as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a) (2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(2) there shall be recognized, and treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits.

(f) CORPORATE SHAREHOLDERS.—In the case of a qualified electing shareholder which is a corporation, the gain shall be recognized only to the extent of the greater of the two following—

(1) the portion of the assets received by it which consists of money, or of stock or securities acquired by the liquidating corporation after December 31, 1953; or

(2) its ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a) (2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed.

SEC. 334. BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS.

(a) GENERAL RULE.—If property is received in a distribution in partial or complete liquidation (other than a distribution to which section 333 applies), and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

(b) LIQUIDATION OF SUBSIDIARY.—

(1) IN GENERAL.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332 (b)), then, except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. If property is received by a corporation in a transfer to which section 332 (c) applies, and if paragraph (2) of this subsection does not apply, then the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.

(2) EXCEPTION.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332 (b)), and if—

(A) the distribution is pursuant to a plan of liquidation adopted—

(i) on or after June 22, 1954, and

(ii) not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) stock of the distributing corporation 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 (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a period of not more than 12 months,

then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary or his delegate, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

(3) PURCHASE DEFINED.—For purposes of paragraph (2) (B), the term "purchase" means any acquisition of stock, but only if—

(A) the basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (ii) under section 1014 (a) (relating to property acquired from a decedent),

(B) the stock is not acquired in an exchange to which section 351 applies, and

(C) the stock is not acquired from a person the ownership of whose stock would, under section 318 (a), be attributed to the person acquiring such stock.

(4) DISTRIBUTEE DEFINED.—For purposes of this subsection, the term "distributee" means only the corporation which meets the 80 percent stock ownership requirements specified in section 332 (b).

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(c) PROPERTY RECEIVED IN LIQUIDATION UNDER SECTION 333.—If—

(1) property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and

(2) with respect to such acquisition—

(A) gain was realized, but

(B) as the result of an election made by the shareholder under section 333, the extent to which gain was recognized was determined under section 333,

then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him.

Subpart B—Effects on Corporation

Sec. 336. General rule.
Sec. 337. Gain or loss on sales or exchanges in connection with certain liquidations.
Sec. 338. Effect on earnings and profits.

SEC. 336. GENERAL RULE.

Except as provided in section 453 (d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) GENERAL RULE.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

(b) PROPERTY DEFINED.—

(1) IN GENERAL.—For purposes of subsection (a), the term "property" does not include—

(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

(B) installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and

(C) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

(2) NONRECOGNITION WITH RESPECT TO INVENTORY IN CERTAIN CASES.—Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term "property" includes—

(A) such property so sold or exchanged, and

(B) installment obligations acquired in respect of such sale or exchange.

(c) LIMITATIONS.—

(1) COLLAPSIBLE CORPORATIONS AND LIQUIDATIONS TO WHICH SECTION 333 APPLIES.—This section shall not apply to any sale or exchange—

(A) made by a collapsible corporation (as defined in section 341 (b)), or

(B) following the adoption of a plan of complete liquidation, if section 333 applies with respect to such liquidation.

(2) LIQUIDATIONS TO WHICH SECTION 332 APPLIES.—In the case of a sale or exchange following the adoption of a plan of complete liquidation, if section 332 applies with respect to such liquidation, then—

(A) if the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334 (b) (1), this section shall not apply; or

(B) if the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334 (b) (2), this section shall apply only to that portion (if any) of the gain which is not greater than the excess of (i) that portion of the adjusted basis (adjusted for any adjustment required under the second sentence of section 334 (b) (2)) of the stock of the liquidating corporation which is allocable, under regulations prescribed by the Secretary or his delegate, to the property sold or exchanged, over (ii) the adjusted basis, in the hands of the liquidating corporation, of the property sold or exchanged.

SEC. 338. EFFECT ON EARNINGS AND PROFITS.

For special rule relating to the effect on earnings and profits of certain distributions in partial liquidation, see section 312 (e).

Subpart C—Collapsible Corporations; Foreign Personal Holding Companies

Sec. 341. Collapsible corporations.
Sec. 342. Liquidation of certain foreign personal holding companies.

SEC. 341. COLLAPSIBLE CORPORATIONS.

(a) TREATMENT OF GAIN TO SHAREHOLDERS.—Gain from—

(1) the sale or exchange of stock of a collapsible corporation,

(2) a distribution in partial or complete liquidation of a collapsible corporation, which distribution is treated under this part as in part or full payment in exchange for stock, and

(3) a distribution made by a collapsible corporation which, under section 301 (c) (3) (A), is treated, to the extent it exceeds the basis

of the stock, in the same manner as a gain from the sale or exchange of property,

to the extent that it would be considered (but for the provisions of this section) as gain from the sale or exchange of a capital asset held for more than 6 months shall, except as provided in subsection (d), be considered as gain from the sale or exchange of property which is not a capital asset.

(b) DEFINITIONS.—

(1) COLLAPSIBLE CORPORATION.—For purposes of this section, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a view to—

(A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and

(B) the realization by such shareholders of gain attributable to such property.

(2) PRODUCTION OR PURCHASE OF PROPERTY.—For purposes of paragraph (1), a corporation shall be deemed to have manufactured, constructed, produced, or purchased property, if—

(A) it engaged in the manufacture, construction, or production of such property to any extent,

(B) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or

(C) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation.

(3) SECTION 341 ASSETS.—For purposes of this section, the term "section 341 assets" means property held for a period of less than 3 years which is—

(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year;

(B) property held by the corporation primarily for sale to customers in the ordinary course of its trade or business;

(C) unrealized receivables or fees, except receivables from sales of property other than property described in this paragraph; or

(D) property described in section 1231 (b) (without regard to any holding period therein provided), except such property which is or has been used in connection with the manufacture, construction, production, or sale of property described in subparagraph (A) or (B).

In determining whether the 3-year holding period specified in this paragraph has been satisfied, section 1223 shall apply, but no such period shall be deemed to begin before the completion of the manufacture, construction, production, or purchase.

(4) UNREALIZED RECEIVABLES.—For purposes of paragraph (3) (C), the term "unrealized receivables or fees" means, to the extent not previously includible in income under the method of accounting used by the corporation, any rights (contractual or otherwise) to payment for—

(A) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(B) services rendered or to be rendered.

(c) PRESUMPTION IN CERTAIN CASES.—

(1) IN GENERAL.—For purposes of this section, a corporation shall, unless shown to the contrary, be deemed to be a collapsible corporation if (at the time of the sale or exchange, or the distribution, described in subsection (a)) the fair market value of its section 341 assets (as defined in subsection (b) (3)) is—

(A) 50 percent or more of the fair market value of its total assets, and

(B) 120 percent or more of the adjusted basis of such section 341 assets.

Absence of the conditions described in subparagraphs (A) and (B) shall not give rise to a presumption that the corporation was not a collapsible corporation.

(2) DETERMINATION OF TOTAL ASSETS.—In determining the fair market value of the total assets of a corporation for purposes of paragraph (1) (A), there shall not be taken into account—

(A) cash,

(B) obligations which are capital assets in the hands of the corporation (and governmental obligations described in section 1221 (5)), and

(C) stock in any other corporation.

(d) LIMITATIONS ON APPLICATION OF SECTION.—In the case of gain realized by a shareholder with respect to his stock in a collapsible corporation, this section shall not apply—

(1) unless, at any time after the commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in subsection (b) (3) or at any time thereafter, such shareholder (A) owned (or was considered as owning) more than 5 percent in value of the outstanding stock of the corporation, or (B) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 5 percent in value of the outstanding stock of the corporation;

(2) to the gain recognized during a taxable year, unless more than 70 percent of such gain is attributable to the property so manufactured, constructed, produced, or purchased; and

(3) to gain realized after the expiration of 3 years following the completion of such manufacture, construction, production, or purchase.

For purposes of paragraph (1), the ownership of stock shall be determined in accordance with the rules prescribed in paragraphs (1), (2), (3), (5), and (6) of section 544 (a) (relating to personal holding companies); except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses

of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

SEC. 342. LIQUIDATION OF CERTAIN FOREIGN PERSONAL HOLDING COMPANIES.

(a) IN GENERAL.—If any distribution—

(1) is, within the meaning of the Internal Revenue Code of 1939, a distribution in partial liquidation or in complete liquidation (including any one of a series of distributions made by the corporation in complete cancellation or redemption of all its stock) and

(2) is made by a foreign corporation which, with respect to any taxable year beginning on or before, and ending after, August 26, 1937, was a foreign personal holding company, and with respect to which a United States group (as defined in section 552 (a) (2)) existed after August 26, 1937, and before January 1, 1938,

then the distribution shall be treated as a distribution in full or part payment in exchange for the stock, and the amount of the gain recognized (determined under section 1002 without regard to this part) resulting from such distribution shall be considered as a gain from the sale or exchange of a capital asset held for not more than 6 months.

(b) SPECIAL RULE FOR CERTAIN LIQUIDATIONS BEFORE 1956.—Subsection (a) shall not apply in the case of a series of distributions in complete liquidation described in subsection (a) if—

(1) the first distribution is made on or after June 22, 1954, and

(2) the final distribution is made before January 1, 1956;

and the amount of the gain recognized (determined under section 1002 without regard to this part) resulting from such distributions shall be considered as a gain from the sale or exchange of a capital asset, or of property which is not a capital asset, as the case may be.

Subpart D—Definition

Sec. 346. Partial liquidation defined.

SEC. 346. PARTIAL LIQUIDATION DEFINED.

(a) IN GENERAL.—For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution 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, including (but not limited to) a distribution which meets the requirements of subsection (b).

For purposes of section 562 (b) (relating to the dividends paid deduction) and section 6043 (relating to information returns), a partial liquidation includes a redemption of stock to which section 302 applies.

(b) TERMINATION OF A BUSINESS.—A distribution shall be treated as a distribution described in subsection (a) (2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has

been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

(c) TREATMENT OF CERTAIN REDEMPTIONS.—The fact that, with respect to a shareholder, a distribution qualifies under section 302 (a) (relating to redemptions treated as distributions in part or full payment in exchange for stock) by reason of section 302 (b) shall not be taken into account in determining whether the distribution, with respect to such shareholder, is also a distribution in partial liquidation of the corporation.

PART III—CORPORATE ORGANIZATIONS AND REORGANIZATIONS

Subpart A. Corporate organizations.
Subpart B. Effects on shareholders and security holders.
Subpart C. Effects on corporations.
Subpart D. Special rule; definitions.

Subpart A—Corporate Organizations

Sec. 351. Transfer to corporation controlled by transferor.

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) GENERAL RULE.—No gain or loss shall 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. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) RECEIPT OF PROPERTY.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) SPECIAL RULE.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all

of the stock which it receives in the exchange to its shareholders shall not be taken into account.

(d) CROSS REFERENCES.—

(1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357.

(2) For the basis of stock, securities, or property received in an exchange to which this section applies, see sections 358 and 362.

(3) For special rule in the case of an exchange described in this section but which results in a gift, see section 2501 and following.

(4) For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see section 61 (a) (1).

Subpart B—Effects on Shareholders and Security Holders

SEC. 354. Exchanges of stock and securities in certain reorganizations.
SEC. 355. Distribution of stock and securities of a controlled corporation.
SEC. 356. Receipt of additional consideration.
SEC. 357. Assumption of liability.
SEC. 358. Basis to distributees.

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) GENERAL RULE.—

(1) IN GENERAL.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(3) CROSS REFERENCE.—

For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) EXCEPTION.—

(1) IN GENERAL.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

(2) CROSS REFERENCE.—

For special rules for certain exchanges in pursuance of plans of reorganization within the meaning of section 368 (a) (1) (D), see section 355.

(c) CERTAIN RAILROAD REORGANIZATIONS.—Notwithstanding any other provision of this subchapter, subsection (a) (1) (and so much of

section 356 as relates to this section) shall apply with respect to a plan of reorganization (whether or not a reorganization within the meaning of section 368 (a)) for a railroad approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act, or under section 20b of the Interstate Commerce Act, as being in the public interest.

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) EFFECT ON DISTRIBUTEES.—

(1) GENERAL RULE.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) NON PRO RATA DISTRIBUTIONS, ETC.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368 (a) (1) (D)).

(3) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1) (D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) CROSS REFERENCE.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) REQUIREMENTS AS TO ACTIVE BUSINESS.—

(1) IN GENERAL.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) DEFINITION.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) GAIN ON EXCHANGES.—

(1) RECOGNITION OF GAIN.—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) TREATMENT AS DIVIDEND.—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(b) ADDITIONAL CONSIDERATION RECEIVED IN CERTAIN DISTRIBUTIONS.—If—

(1) section 355 would apply to a distribution but for the fact that

(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

(c) LOSS.—If—

(1) section 354 would apply to an exchange, or section 355 would apply to an exchange or distribution, but for the fact that

(2) the property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money,

then no loss from the exchange or distribution shall be recognized.

(d) SECURITIES AS OTHER PROPERTY.—For purposes of this section—

(1) IN GENERAL.—Except as provided in paragraph (2), the term "other property" includes securities.

(2) EXCEPTIONS.—

(A) SECURITIES WITH RESPECT TO WHICH NONRECOGNITION OF GAIN WOULD BE PERMITTED.—The term "other property" does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.

(B) GREATER PRINCIPAL AMOUNT IN SECTION 354 EXCHANGE.—If—

(i) in an exchange described in section 354 (other than subsection (c) thereof), securities of a corporation a party to the

reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered,

then, with respect to such securities received, the term "other property" means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (C), if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

(C) GREATER PRINCIPAL AMOUNT IN SECTION 355 TRANSACTION.—If, in an exchange or distribution described in section 355, the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities in the distributing corporation which are surrendered, then, with respect to such securities received, the term "other property" means only the fair market value of such excess.

(e) EXCHANGES FOR SECTION 306 STOCK.—Notwithstanding any other provision of this section, to the extent that any of the other property (or money) is received in exchange for section 306 stock, an amount equal to the fair market value of such other property (or the amount of such money) shall be treated as a distribution of property to which section 301 applies.

(f) TRANSACTIONS INVOLVING GIFT OR COMPENSATION.—

For special rules for a transaction described in section 354, 355, or this section, but which—

(1) results in a gift, see section 2501 and following, or

(2) has the effect of the payment of compensation, see section 61 (a) (1).

SEC. 357. ASSUMPTION OF LIABILITY.

(a) GENERAL RULE.—Except as provided in subsections (b) and (c), if—

(1) the taxpayer receives property which would be permitted to be received under section 351, 361, or 371 without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability,

then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351, 361, or 371, as the case may be.

(b) TAX AVOIDANCE PURPOSE.—

(1) IN GENERAL.—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose,

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351, 361, or 371 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) BURDEN OF PROOF.—In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

(c) LIABILITIES IN EXCESS OF BASIS.—

(1) IN GENERAL.—In the case of an exchange—

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368 (a) (1) (D),

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) EXCEPTIONS.—Paragraph (1) shall not apply to any exchange to which—

(A) subsection (b) (1) of this section applies, or

(B) section 371 applies.

SEC. 358. BASIS TO DISTRIBUTEES.

(a) GENERAL RULE.—In the case of an exchange to which section 351, 354, 355, 356, 361, or 371 (b) applies—

(1) NONRECOGNITION PROPERTY.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer, and

(ii) the amount of any money received by the taxpayer, and

(B) increased by—

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) OTHER PROPERTY.—The basis of any other property (except money) received by the taxpayer shall be its fair market value.

(b) ALLOCATION OF BASIS.—

(1) IN GENERAL.—Under regulations prescribed by the Secretary or his delegate, the basis determined under subsection (a) (1) shall be allocated among the properties permitted to be received without the recognition of gain or loss.

(2) SPECIAL RULE FOR SECTION 355.—In the case of an exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then in making the allocation under paragraph (1) of this subsection, there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation which are retained, and the allocation of basis shall be made among all such properties.

(c) SECTION 355 TRANSACTIONS WHICH ARE NOT EXCHANGES.—For purposes of this section, a distribution to which section 355 (or so

much of section 356 as relates to section 355) applies shall be treated as an exchange, and for such purposes the stock and securities of the distributing corporation which are retained shall be treated as surrendered, and received back, in the exchange.

(d) ASSUMPTION OF LIABILITY.—Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

(e) EXCEPTION.—This section shall not apply to property acquired by a corporation by the issuance of its stock or securities as consideration in whole or in part for the transfer of the property to it.

Subpart C—Effects on Corporation

Sec. 361. Nonrecognition of gain or loss to corporations.
Sec. 362. Basis to corporations.
Sec. 363. Effect on earnings and profits.

SEC. 361. NONRECOGNITION OF GAIN OR LOSS TO CORPORATIONS.

(a) GENERAL RULE.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(b) EXCHANGES NOT SOLELY IN KIND.—

(1) GAIN.—If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also of other property or money, then—

(A) if the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(B) if the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(2) LOSS.—If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of property permitted by subsection (a) 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.

SEC. 362. BASIS TO CORPORATIONS.

(a) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN SURPLUS.—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, or

(2) as paid-in surplus or as a contribution to capital,

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.

(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 issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

(c) SPECIAL RULE FOR CERTAIN CONTRIBUTIONS TO CAPITAL.—

(1) PROPERTY OTHER THAN MONEY.—Notwithstanding subsection (a) (2), if property other than money—

(A) is acquired by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such,

then the basis of such property shall be zero.

(2) MONEY.—Notwithstanding subsection (a) (2), if money—

(A) is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such,

then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary or his delegate.

SEC. 363. EFFECT ON EARNINGS AND PROFITS.

For rules relating to the effect on earnings and profits of transactions to which this part applies, see sections 312 and 381.

Subpart D—Special Rule; Definitions

Sec. 367. Foreign corporations.
Sec. 368. Definitions relating to corporate reorganizations.

SEC. 367. FOREIGN CORPORATIONS.

In determining the extent to which gain shall be recognized in the case of any of the exchanges described in section 332, 351, 354, 355, 356, or 361, 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 his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) REORGANIZATION.—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, 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);

(C) 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 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 other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

(2) SPECIAL RULES RELATING TO PARAGRAPH (1).—

(A) REORGANIZATIONS DESCRIBED IN BOTH PARAGRAPH (1) (C) AND PARAGRAPH (1) (D).—If a transaction is described in both paragraph (1) (C) and paragraph (1) (D), then, for purposes of this subchapter, such transaction shall be treated as described only in paragraph (1) (D).

(B) ADDITIONAL CONSIDERATION IN CERTAIN PARAGRAPH (1) (C) CASES.—If—

(i) one corporation acquires substantially all of the properties of another corporation,

(ii) the acquisition would qualify under paragraph (1) (C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1) (C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation,

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1) (C). Solely for the purpose of determining whether clause (iii) of the

preceding sentence applies, the amount of any liability assumed by the acquiring corporation, and the amount of any liability to which any property acquired by the acquiring corporation is subject, shall be treated as money paid for the property.

(C) TRANSFERS OF ASSETS TO SUBSIDIARIES IN CERTAIN PARAGRAPH (1) (A) AND (1) (C) CASES.—A transaction otherwise qualifying under paragraph (1) (A) or paragraph (1) (C) shall not be disqualified by reason of the fact that part or all of the assets which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets.

(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) (C) of subsection (a), if the stock exchanged for the 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) 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 are transferred.

(c) CONTROL.—For purposes of part I (other than section 304), part II, and this part, the term "control" means 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.

PART IV—INSOLVENCY REORGANIZATIONS

Sec. 371. Reorganization in certain receivership and bankruptcy proceedings.
Sec. 372. Basis in connection with certain receivership and bankruptcy proceedings.
Sec. 373. Loss not recognized in certain railroad reorganizations.

SEC. 371. REORGANIZATION IN CERTAIN RECEIVERSHIP AND BANKRUPTCY PROCEEDINGS.

(a) EXCHANGES BY CORPORATIONS.—

(1) IN GENERAL.—No gain or loss shall be recognized if property of a corporation (other than a railroad corporation, as defined in section 77 (m) of the Bankruptcy Act (49 Stat. 922; 11 U. S. C. 205)) is transferred in pursuance of an order of the court having jurisdiction of such corporation—

(A) in a receivership, foreclosure, or similar proceeding, or

(B) in a proceeding under chapter X of the Bankruptcy Act (52 Stat. 883–905; 11 U. S. C., chapter 10) or the corresponding provisions of prior law,

to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation.

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(2) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of paragraph (1) if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by paragraph (1) to be received without the recognition of gain, but also of other property or money, then—

(A) if the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(B) if the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(b) EXCHANGES BY SECURITY HOLDERS.—

(1) IN GENERAL.—No gain or loss shall be recognized on an exchange consisting of the relinquishment or extinguishment of stock or securities in a corporation the plan of reorganization of which is approved by the court in a proceeding described in subsection (a), in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate such plan of reorganization.

(2) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of paragraph (1) if it were not for the fact that the property received in exchange consists not only of property permitted by paragraph (1) to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) LOSS FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a) (1) or (b) (1) if it were not for the fact that the property received in exchange consists not only of property permitted by subsection (a) (1) or (b) (1) 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.

(d) ASSUMPTION OF LIABILITIES.—In the case of a transaction involving an assumption of a liability or the acquisition of property subject to a liability, the rules provided in section 357 shall apply.

SEC. 372. BASIS IN CONNECTION WITH CERTAIN RECEIVERSHIP AND BANKRUPTCY PROCEEDINGS.

(a) CORPORATION.—If property was acquired by a corporation in a transfer to which—

(1) section 371 (a) applies,

(2) so much of section 371 (c) as relates to section 371 (a) (1) applies, or

(3) the corresponding provisions of prior law apply,

then notwithstanding the provisions of section 270 of the Bankruptcy Act (54 Stat. 709; 11 U. S. C. 670), the basis in the hands of the acquiring corporation shall be the same as it would be in the hands of the corporation whose property was so acquired, increased in the

amount of gain recognized to the corporation whose property was so acquired under the law applicable to the year in which the acquisition occurred, and such basis shall not be adjusted under section 1017 by reason of a discharge of indebtedness in pursuance of the plan of reorganization under which such transfer was made.

(b) STOCK OR SECURITY HOLDER.—

For basis of stock or securities acquired under section 371 (b), see section 358.

SEC. 373. LOSS NOT RECOGNIZED IN CERTAIN RAILROAD REORGANIZATIONS.

(a) NONRECOGNITION OF LOSS.—No loss shall be recognized if property of a railroad corporation, as defined in section 77 (m) of the Bankruptcy Act (49 Stat. 922; 11 U. S. C. 205), is transferred in pursuance of an order of the court having jurisdiction of such corporation—

(1) in a receivership proceeding, or

(2) in a proceeding under section 77 of the Bankruptcy Act,

to a railroad corporation (as defined in section 77 (m) of the Bankruptcy Act) organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding.

(b) BASIS.—

(1) RAILROAD CORPORATIONS.—If the property of a railroad corporation (as defined in section 77 (m) of the Bankruptcy Act) was acquired after December 31, 1938, in pursuance of an order of the court having jurisdiction of such corporation—

(A) in a receivership proceeding, or

(B) in a proceeding under section 77 of the Bankruptcy Act,

and the acquiring corporation is a railroad corporation (as defined in section 77 (m) of the Bankruptcy Act) organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, the basis shall be the same as it would be in the hands of the railroad corporation whose property was so acquired.

(2) PROPERTY ACQUIRED BY STREET, SUBURBAN, OR INTERURBAN ELECTRIC RAILWAY CORPORATION.—If the property of any street, suburban, or interurban electric railway corporation engaged as a common carrier in the transportation of persons or property in interstate commerce was acquired after December 31, 1934, in pursuance of an order of the court having jurisdiction of such corporation in a proceeding under section 77B of the Bankruptcy Act (48 Stat. 912), and the acquiring corporation is a street, suburban, or interurban electric railway engaged as a common carrier in the transportation of persons or property in interstate commerce, organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, then, notwithstanding the provisions of section 270 of the Bankruptcy Act (52 Stat. 904; 11 U. S. C. 670), the basis shall be the same as it would be in the hands of the corporation whose property was so acquired.

PART V—CARRYOVERS

Sec. 381. Carryovers in certain corporate acquisitions.
Sec. 382. Special limitations on net operating loss carryovers.

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) General Rule.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334 (b) (2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354 (b) (1) are met), or (F) of section 368 (a) (1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

(b) Operating Rules.—Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368 (a) (1)—

(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.

(2) For purposes of this section, the date of distribution or transfer shall be the day on which the distribution or transfer is completed; except that, under regulations prescribed by the Secretary or his delegate, the date when substantially all of the property has been distributed or transferred may be used if the distributor or transferor corporation ceases all operations, other than liquidating activities, after such date.

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

(c) Items of the Distributor or Transferor Corporation.—The items referred to in subsection (a) are:

(1) Net operating loss carryovers.—The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation are first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) In determining the net operating loss deduction, the portion of such deduction attributable to the net operating loss carryovers of the distributor or transferor corporation to the first taxable year of the acquiring corporation ending after the date of distribution or transfer shall be limited to an amount which bears the same ratio to the taxable income (determined without

regard to a net operating loss deduction) of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For the purpose of determining the amount of the net operating loss carryovers under section 172 (b) (2), a net operating loss for a taxable year (hereinafter in this subparagraph referred to as the "loss year") of a distributor or transferor corporation which ends on or before the end of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. For the same purpose, the taxable income for a "prior taxable year" (as the term is used in section 172 (b) (2)) shall be computed as provided in such section; except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation—

(i) such taxable year shall (for the purpose of this subparagraph only) be considered to be 2 taxable years (hereinafter in this subparagraph referred to as the "pre-acquisition part year" and the "post-acquisition part year");

(ii) the pre-acquisition part year shall begin on the same day as such taxable year begins and shall end on the date of distribution or transfer;

(iii) the post-acquisition part year shall begin on the day following the date of distribution or transfer and shall end on the same day as the end of such taxable year;

(iv) the taxable income for such taxable year (computed with the modifications specified in section 172 (b) (2) (A) but without a net operating loss deduction) shall be divided between the pre-acquisition part year and the post-acquisition part year in proportion to the number of days in each;

(v) the net operating loss deduction for the pre-acquisition part year shall be determined as provided in section 172 (b) (2) (B), but without regard to a net operating loss year of the distributor or transferor corporation; and

(vi) the net operating loss deduction for the post-acquisition part year shall be determined as provided in section 172 (b) (2) (B).

(2) EARNINGS AND PROFITS.—In the case of a distribution or transfer described in subsection (a)—

(A) the earnings and profits or deficit in earnings and profits, as the case may be, of the distributor or transferor corporation shall, subject to subparagraph (B), be deemed to have been received or incurred by the acquiring corporation as of the close of the date of the distribution or transfer; and

(B) a deficit in earnings and profits of the distributor, transferor, or acquiring corporation shall be used only to offset earnings and profits accumulated after the date of transfer. For this purpose, the earnings and profits for the taxable year of the acquiring corporation in which the distribution or transfer occurs shall be deemed to have been accumulated after such distribution or transfer in an amount which bears the same ratio

to the undistributed earnings and profits of the acquiring corporation for such taxable year (computed without regard to any earnings and profits received from the distributor or transferor corporation, as described in subparagraph (A) of this paragraph) as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(3) CAPITAL LOSS CARRYOVER.—The capital loss carryover determined under section 1212, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the capital loss carryover of the distributor or transferor corporation is first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) The capital loss carryover shall be a short-term capital loss in the taxable year determined under subparagraph (A) but shall be limited to an amount which bears the same ratio to the net capital gain (determined without regard to a short-term capital loss attributable to capital loss carryover), if any, of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For purposes of determining the amount of such capital loss carryover to taxable years following the taxable year determined under subparagraph (A), the net capital gain in the taxable year determined under subparagraph (A) shall be considered to be an amount equal to the amount determined under subparagraph (B).

(4) METHOD OF ACCOUNTING.—The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary or his delegate.

(5) INVENTORIES.—In any case in which inventories are received by the acquiring corporation, such inventories shall be taken by such corporation (in determining its income) on the same basis on which such inventories were taken by the distributor or transferor corporation, unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of taking inventory adopted pursuant to regulations prescribed by the Secretary or his delegate.

(6) METHOD OF COMPUTING DEPRECIATION ALLOWANCE.—The acquiring corporation shall be treated as the distributor or transferor corporation for purposes of computing the depreciation allowance under paragraphs (2), (3), and (4) of section 167 (b) on property acquired in a distribution or transfer with respect to that part or

all of the basis in the hands of the acquiring corporation as does not exceed the basis in the hands of the distributor or transferor corporation.

(7) PREPAID INCOME.—If the acquiring corporation assumes the liability described in section 452 (e) (2) with respect to prepaid income of a distributor or transferor corporation which had elected, under section 452 (d), to report such income as provided in section 452, the acquiring corporation shall be treated, for this purpose, as if it were the distributor or transferor corporation, unless the acquiring corporation, after the date of distribution or transfer, uses the cash receipts and disbursements method of accounting. In the latter case, the acquiring corporation shall include in gross income for the first taxable year ending after the date of distribution or transfer, so much of such prepaid income as was not includible in gross income of the distributor or transferor corporation under section 452 for preceding taxable years.

(8) INSTALLMENT METHOD.—If the acquiring corporation acquires installment obligations (the income from which the distributor or transferor corporation has elected, under section 453, to report on the installment basis) the acquiring corporation shall, for purposes of section 453, be treated as if it were the distributor or transferor corporation.

(9) AMORTIZATION OF BOND DISCOUNT OR PREMIUM.—If the acquiring corporation assumes liability for bonds of the distributor or transferor corporation issued at a discount or premium, the acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of determining the amount of amortization allowable or includible with respect to such discount or premium.

(10) TREATMENT OF CERTAIN EXPENSES DEFERRED BY THE ELECTION OF DISTRIBUTOR OR TRANSFEROR CORPORATION.—The acquiring corporation shall be entitled to deduct, as if it were the distributor or transferor corporation, expenses deferred under sections 615 and 616 (relating to exploration and development expenditures, respectively) if the distributor or transferor corporation has so elected. For the purpose of applying the limitation provided in section 615, if, for any taxable year, the distributor or transferor corporation was allowed the deduction in section 615 (a) or made the election in section 615 (b), the acquiring corporation shall be deemed to have been allowed such deduction or to have made such election, as the case may be.

(11) CONTRIBUTIONS TO PENSION PLANS, EMPLOYEES' ANNUITY PLANS, AND STOCK BONUS AND PROFIT-SHARING PLANS.—The acquiring corporation shall be considered to be the distributor or transferor corporation after the date of distribution or transfer for the purpose of determining the amounts deductible under section 404 with respect to pension plans, employees' annuity plans, and stock bonus and profit-sharing plans.

(12) RECOVERY OF BAD DEBTS, PRIOR TAXES, OR DELINQUENCY AMOUNTS.—If the acquiring corporation is entitled to the recovery of bad debts, prior taxes, or delinquency amounts previously deducted or credited by the distributor or transferor corporation, the

acquiring corporation shall include in its income such amounts as would have been includible by the distributor or transferor corporation in accordance with section 111 (relating to the recovery of bad debts, prior taxes, and delinquency amounts).

(13) INVOLUNTARY CONVERSIONS UNDER SECTION 1033.—The acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of applying section 1033.

(14) DIVIDEND CARRYOVER TO PERSONAL HOLDING COMPANY.—The dividend carryover (described in section 564) to taxable years ending after the date of distribution or transfer.

(15) INDEBTEDNESS OF CERTAIN PERSONAL HOLDING COMPANIES.—The acquiring corporation shall be considered to be the distributor or transferor corporation for the purpose of determining the applicability of section 545 (b) (7), relating to a deduction for payment of certain indebtedness incurred before January 1, 1934.

(16) CERTAIN OBLIGATIONS OF DISTRIBUTOR OR TRANSFEROR CORPORATION.—If the acquiring corporation—

(A) assumes an obligation of the distributor or transferor corporation which, after the date of the distribution or transfer, gives rise to a liability, and

(B) such liability, if paid or accrued by the distributor or transferor corporation, would have been deductible in computing its taxable income,

the acquiring corporation shall be entitled to deduct such items when paid or accrued, as the case may be, as if such corporation were the distributor or transferor corporation. A corporation which would have been an acquiring corporation under this section if the date of distribution or transfer had occurred on or after the effective date of the provisions of this subchapter applicable to a liquidation or reorganization, as the case may be, shall be entitled, even though the date of distribution or transfer occurred before such effective date, to apply this paragraph with respect to amounts paid or accrued in taxable years beginning after December 31, 1953, on account of such obligations of the distributor or transferor corporation. This paragraph shall not apply if such obligations are reflected in the amount of stock, securities, or property transferred by the acquiring corporation to the transferor corporation for the property of the transferor corporation.

(17) DEFICIENCY DIVIDEND OF PERSONAL HOLDING COMPANY.—If the acquiring corporation pays a deficiency dividend (as defined in section 547 (d)) with respect to the distributor or transferor corporation, such distributor or transferor corporation shall, with respect to such payments, be entitled to the deficiency dividend deduction provided in section 547.

(18) PERCENTAGE DEPLETION ON EXTRACTION OF ORES OR MINERALS FROM THE WASTE OR RESIDUE OF PRIOR MINING.—The acquiring corporation shall be considered to be the distributor or transferor corporation for the purpose of determining the applicability of section 613 (c) (3) (relating to extraction of ores or minerals from the ground).

(19) CHARITABLE CONTRIBUTIONS IN EXCESS OF PRIOR YEARS' LIMITATION.—Contributions made in the taxable year ending on the date of distribution or transfer and the prior taxable year by the distributor or transferor corporation in excess of the amount deductible under section 170 (b) (2) in such taxable years shall be deductible by the acquiring corporation in its first two taxable years which begin after the date of distribution or transfer, subject to the limitations imposed in section 170 (b) (2).

SEC. 382. SPECIAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS.

(a) PURCHASE OF A CORPORATION AND CHANGE IN ITS TRADE OR BUSINESS.—

(1) IN GENERAL.—If, at the end of a taxable year of a corporation—

(A) any one or more of those persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to—

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, and

(C) such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock,

the net operating loss carryovers, if any, from prior taxable years of such corporation to such taxable year and subsequent taxable years shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years.

(2) DESCRIPTION OF PERSON OR PERSONS.—The person or persons referred to in paragraph (1) shall be the 10 persons (or such lesser number as there are persons owning the outstanding stock at the end of such taxable year) who own the greatest percentage of the fair market value of such stock at the end of such taxable year; except that, if any other person owns the same percentage of such stock at such time as is owned by one of the 10 persons, such person shall also be included. If any of the persons are so related that such stock owned by one is attributed to the other under the rules specified in paragraph (3), such persons shall be considered as only one person solely for the purpose of selecting the 10 persons (more or less) who own the greatest percentage of the fair market value of such outstanding stock.

(3) ATTRIBUTION OF OWNERSHIP.—Section 318 (relating to constructive ownership of stock) shall apply in determining the ownership of stock, except that section 318 (a) (2) (C) shall be applied without regard to the 50 percent limitation contained therein.

(4) DEFINITION OF PURCHASE.—For purposes of this subsection, the term "purchase" means the acquisition of stock, the basis of which is determined solely by reference to its cost to the holder thereof, in a transaction from a person or persons other than the person or persons the ownership of whose stock would be attributed to the holder by application of paragraph (3).

(b) CHANGE OF OWNERSHIP AS THE RESULT OF A REORGANIZATION.—

(1) IN GENERAL.—If, in the case of a reorganization specified in paragraph (2) of section 381 (a), the transferor corporation or the acquiring corporation—

(A) has a net operating loss which is a net operating loss carryover to the first taxable year of the acquiring corporation ending after the date of transfer, and

(B) the stockholders (immediately before the reorganization) of such corporation (hereinafter in this subsection referred to as the "loss corporation"), as the result of owning stock of the loss corporation, own (immediately after the reorganization) less than 20 percent of the fair market value of the outstanding stock of the acquiring corporation,

the total net operating loss carryover from prior taxable years of the loss corporation to the first taxable year of the acquiring corporation ending after the date of transfer shall be reduced by the percentage determined under paragraph (2).

(2) REDUCTION OF NET OPERATING LOSS CARRYOVER.—The reduction applicable under paragraph (1) shall be the percentage determined by subtracting from 100 percent—

(A) the percent of the fair market value of the outstanding stock of the acquiring corporation owned (immediately after the reorganization) by the stockholders (immediately before the reorganization) of the loss corporation, as the result of owning stock of the loss corporation, multiplied by

(B) five.

(3) EXCEPTION TO LIMITATION IN THIS SUBSECTION.—The limitation in this subsection shall not apply if the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportion.

(4) NET OPERATING LOSS CARRYOVERS TO SUBSEQUENT YEARS.—In computing the net operating loss carryovers to taxable years subsequent to a taxable year in which there was a limitation applicable to a net operating loss carryover by operation of this subsection, the income in such taxable year, as computed under section 172 (b) (2), shall be increased by the amount of the reduction of the total net operating loss carryover determined under paragraph (2).

(5) ATTRIBUTION OF OWNERSHIP.—If the transferor corporation or the acquiring corporation owns (immediately before the reorganization) any of the outstanding stock of the loss corporation, such transferor corporation or acquiring corporation shall, for purposes

of this subsection, be treated as owning (immediately after the reorganization) a percentage of the fair market value of the acquiring corporation's outstanding stock which bears the same ratio to the percentage of the fair market value of the outstanding stock of the loss corporation (immediately before the reorganization) owned by such transferor corporation or acquiring corporation as the fair market value of the total outstanding stock of the loss corporation (immediately before the reorganization) bears to the fair market value of the total outstanding stock of the acquiring corporation (immediately after the reorganization).

(6) STOCK OF CORPORATION CONTROLLING ACQUIRING CORPORATION.—If the stockholders of the loss corporation (immediately before the reorganization) own, as a result of the reorganization, stock in a corporation controlling the acquiring corporation, such stock of the controlling corporation shall, for purposes of this subsection, be treated as stock of the acquiring corporation in an amount valued at an equivalent fair market value.

(c) DEFINITION OF STOCK.—For purposes of this section, "stock" means all shares except nonvoting stock which is limited and preferred as to dividends.

PART VI—EFFECTIVE DATE OF SUBCHAPTER C

Sec. 391. Effective date of part I.
Sec. 392. Effective date of part II.
Sec. 393. Effective dates of parts III and IV.
Sec. 394. Effective date of part V.
Sec. 395. Special rules for application of this subchapter.

SEC. 391. EFFECTIVE DATE OF PART I.

Except as otherwise provided in this subchapter, part I shall take effect on June 22, 1954. Section 306 shall apply only with respect to dispositions (or redemptions) occurring on or after June 22, 1954.

SEC. 392. EFFECTIVE DATE OF PART II.

(a) GENERAL RULE.—Except as otherwise provided in this subchapter, part II shall apply with respect to a plan of liquidation only if the first distribution in pursuance of such plan occurs on or after June 22, 1954. Section 341 shall apply only with respect to sales, exchanges, and distributions on or after June 22, 1954.

(b) SPECIAL RULE FOR CERTAIN SALES DURING 1954.—

(1) NONRECOGNITION OF GAIN OR LOSS.—If—

(A) all of the assets of a corporation (less assets retained to meet claims) are distributed before January 1, 1955, in complete liquidation of such corporation; and

(B) the corporation elects (at such time and in such manner as the Secretary or his delegate may by regulations prescribe) to have this subsection apply,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property during the calendar year 1954.

(2) CERTAIN PROVISIONS OF SECTION 337 MADE APPLICABLE.—For purposes of paragraph (1)—

(A) the term "property" has the meaning given to such term by section 337 (b); except that any determination required by

section 337 (b) to be made by reference to the date of the adoption of the plan of liquidation shall be made by reference to January 1, 1954; and

(B) the limitations of section 337 (c) shall apply.

For purposes of section 453 (d) (4) (B) (relating to disposition of installment obligations), nonrecognition of gain or loss under paragraph (1) of this subsection shall be treated as nonrecognition of gain or loss under section 337.

(3) PLANS OF LIQUIDATION ADOPTED AFTER DECEMBER 31, 1953, AND BEFORE JUNE 22, 1954.—If the plan of complete liquidation was adopted after December 31, 1953, and before June 22, 1954, then, at the election of the corporation (made at such time and in such manner as the Secretary or his delegate may by regulations prescribe)—

(A) the 12-month period beginning on the date of the adoption of such plan shall be (i) the period for distribution (in lieu of the requirement in paragraph (1) (A) of this subsection that the assets be distributed before January 1, 1955), and (ii) the period during which, by reason of paragraph (1) of this subsection, gain or loss to the corporation is not recognized (in lieu of nonrecognition of gain or loss during the calendar year 1954); and

(B) notwithstanding paragraph (2) (A) of this subsection, any determination required by section 337 (b) to be made by reference to the date of the adoption of the plan of liquidation shall be made by reference to such date (and not by reference to January 1, 1954).

SEC. 393. EFFECTIVE DATES OF PARTS III AND IV.

(a) GENERAL RULE.—Except as otherwise provided in this subchapter, parts III and IV shall take effect on June 22, 1954.

(b) SPECIAL RULES FOR PLANS OF REORGANIZATION.—

(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), parts III and IV shall apply only in respect of plans of reorganization adopted on or after June 22, 1954. For purposes of this paragraph and paragraphs (2) and (3), a plan to make a transfer to a controlled corporation described in section 351, or a plan to make an exchange or distribution which is described in section 355 (or so much of section 356 as relates to section 355) shall be treated as a plan of reorganization.

(2) ELECTION TO HAVE 1939 CODE APPLY.—If—

(A) a plan of reorganization was submitted to the Secretary or his delegate before June 22, 1954, but such plan was not adopted before such date,

(B) the Secretary or his delegate issues (whether before, on, or after such date) a ruling with respect to such plan, and

(C) the corporations which are parties to the reorganization elect (at such time and in such manner as the Secretary or his delegate may by regulations prescribe) to have this paragraph apply,

then, if such reorganization is completed in accordance with the plan so submitted, the tax treatment of such reorganization (as to the corporations which are parties to the reorganization and as to

their shareholders and security holders) shall be determined under the Internal Revenue Code of 1939 (in accordance with the contents of such ruling) and not under this Code.

(3) ELECTION TO HAVE 1954 CODE APPLY.—If—

(A) a plan of reorganization—

(i) was adopted after March 1, 1954, and before June 22, 1954, or

(ii) was adopted before June 22, 1954, in pursuance of a court order and all distributions under the plan occur after March 1, 1954, and before July 1, 1954, and

(B) the corporations which are parties to the reorganization elect (at such time and in such manner as the Secretary or his delegate may by regulations prescribe) to have this paragraph apply,

then the tax treatment of such reorganization (as to the corporations which are parties to the reorganization and as to their shareholders and security holders) shall be determined under this Code and not under the Internal Revenue Code of 1939.

SEC. 394. EFFECTIVE DATE OF PART V.

(a) SECTION 381.—Except as otherwise provided in this subchapter, section 381 shall apply to liquidations and reorganizations, the tax treatment of which is determined under this Code.

(b) SECTION 382 (a).—For purposes of applying the special limitation on net operating loss carryovers in section 382 (a), the beginning of the taxable years specified in clauses (i) and (ii) of section 382 (a) (1) (A) shall be considered to be the beginning of such taxable years or June 22, 1954, whichever occurs later.

(c) SECTION 382 (b).—Section 382 (b) shall apply to reorganizations, the tax treatment of which is determined under this Code.

SEC. 395. SPECIAL RULES FOR APPLICATION OF THIS SUBCHAPTER.

(a) TAXABLE YEARS AFFECTED.—Any provision of this subchapter the applicability of which is stated in terms of a specific date shall apply with respect to taxable years ending after such date. Each provision shall, in the case of a taxable year subject to the Internal Revenue Code of 1939, be deemed to be included in the Internal Revenue Code of 1939, but shall apply only to taxable years ending after such specific date.

(b) REPEAL AND CONTINUANCE OF INTERNAL REVENUE CODE OF 1939.—To the extent that the provisions of this subchapter supersede the provisions of the Internal Revenue Code of 1939, such provisions of the Internal Revenue Code of 1939 are hereby repealed. The provisions of the Internal Revenue Code of 1939 shall continue to apply with respect to transactions for which rules are provided in this subchapter until such rules take effect.

Subchapter D—Deferred Compensation, Etc.

Part I. Pension, profit-sharing, stock bonus plans, etc.
Part II. Miscellaneous provisions.

PART I—PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

Sec. 401. Qualified pension, profit-sharing, and stock bonus plans.
Sec. 402. Taxability of beneficiary of employees' trust.
Sec. 403. Taxation of employee annuities.
Sec. 404. Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan.

SEC. 401. QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS.

(a) REQUIREMENTS FOR QUALIFICATION.—A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404 (a) (3) (B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

(3) if the trust, or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under this subsection which benefits either—

(A) 70 percent or more of all the employees, or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan, excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding 5 years, employees whose customary employment is for not more than 20 hours in any one week, and employees whose customary employment is for not more than 5 months in any calendar year, or

(B) such employees as qualify under a classification set up by the employer and found by the Secretary or his delegate not to

be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees; and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(5) A classification shall not be considered discriminatory within the meaning of paragraph (3) (B) or (4) merely because it excludes employees the whole of whose remuneration constitutes "wages" under section 3121 (a) (1) (relating to the Federal Insurance Contributions Act) or merely because it is limited to salaried or clerical employees. Neither shall a plan be considered discriminatory within the meaning of such provisions merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, or merely because the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" by section 3121 (a) (1) differ from the contributions or benefits based on employee's remuneration not so excluded, or differ because of any retirement benefits created under State or Federal law.

(6) A plan shall be considered as meeting the requirements of paragraph (3) during the whole of any taxable year of the plan if on one day in each quarter it satisfied such requirements.

(b) CERTAIN RETROACTIVE CHANGES IN PLAN.—A stock bonus, pension, profit-sharing, or annuity plan shall be considered as satisfying the requirements of paragraphs (3), (4), (5), and (6) of subsection (a) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put in effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period.

(c) CROSS REFERENCE.—

For exemption from tax of a trust qualified under this section, see section 501 (a).

SEC. 402. TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST.

(a) TAXABILITY OF BENEFICIARY OF EXEMPT TRUST.—

(1) GENERAL RULE.—Except as provided in paragraph (2), the amount actually distributed or made available to any distributee by any employees' trust described in section 401 (a) which is exempt from tax under section 501 (a) shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities) except that section 72 (e) (3) shall not apply. The amount actually distributed or made available to any distributee shall not include net unrealized appreciation in securities of the employer corporation attributable to the amount contributed by the employee. Such net unrealized appreciation and the resulting adjustments to basis of such securities shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(2) CAPITAL GAINS TREATMENT FOR CERTAIN DISTRIBUTIONS.—In the case of an employees' trust described in section 401 (a), which is exempt from tax under section 501 (a), if the total distributions payable with respect to any employee are paid to the distributee within 1 taxable year of the distributee on account of the employee's death or other separation from the service, or on account of the death of the employee after his separation from the service, the amount of such distribution, to the extent exceeding the amounts contributed by the employee (determined by applying section 72 (f)), which employee contributions shall be reduced by any amounts theretofore distributed to him which were not includible in gross income, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. Where such total distributions include securities of the employer corporation, there shall be excluded from such excess the net unrealized appreciation attributable to that part of the total distributions which consists of the securities of the employer corporation so distributed. The amount of such net unrealized appreciation and the resulting adjustments to basis of the securities of the employer corporation so distributed shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(3) DEFINITIONS.—For purposes of this subsection—

(A) The term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form.

(B) The term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in section 421 (d) (2) and (3)) of the employer corporation.

(C) The term "total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death or other separation from the service, or on account of his death after separation from the service.

(b) TAXABILITY OF BENEFICIARY OF NON-EXEMPT TRUST.—Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501 (a) shall be included in the gross income of an employee for the taxable year in which the contribution is made to the trust in the case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made. The amount actually distributed or made available to any distributee by any such trust shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities) except that section 72 (e) (3) shall not apply.

(c) TAXABILITY OF BENEFICIARY OF CERTAIN FOREIGN SITUS TRUSTS.—For purposes of subsections (a) and (b), a stock bonus, pension, or profit-sharing trust which would qualify for exemption from tax under section 501 (a) except for the fact that it is a trust created or organized outside the United States shall be treated as if it were a trust exempt from tax under section 501 (a).

(d) CERTAIN EMPLOYEES' ANNUITIES.—Notwithstanding subsection (b) or any other provision of this subtitle, a contribution to a trust by an employer shall not be included in the gross income of the employee in the year in which the contribution is made if—

(1) such contribution is to be applied by the trustee for the purchase of annuity contracts for the benefit of such employee;

(2) such contribution is made to the trustee pursuant to a written agreement entered into prior to October 21, 1942, between the employer and the trustee, or between the employer and the employee; and

(3) under the terms of the trust agreement the employee is not entitled during his lifetime, except with the consent of the trustee, to any payments under annuity contracts purchased by the trustee other than annuity payments.

The employee shall include in his gross income the amounts received under such contracts for the year received as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply. This subsection shall have no application with respect to amounts contributed to a trust after June 1, 1949, if the trust on such date was exempt under section 165 (a) of the Internal Revenue Code of 1939. For purposes of this subsection, amounts paid by an employer for the purchase of annuity contracts which are transferred to the trustee shall be deemed to be contributions made to a trust or trustee and contributions applied by the trustee for the purchase of annuity contracts; the term "annuity contracts purchased by the trustee" shall include annuity contracts so purchased by the employer and transferred to the trustee; and the term "employee" shall include only a person who was in the employ of the employer, and was covered by the agreement referred to in paragraph (2), prior to October 21, 1942.

(e) CERTAIN PLAN TERMINATIONS.—For purposes of subsection (a) (2), distributions made after December 31, 1953, and before January 1, 1955, as a result of the complete termination of a stock bonus, pension, or profit-sharing plan of an employer which is a corporation, if the termination of the plan is incident to the complete liquidation, occurring before the date of enactment of this title, of the corporation, whether or not such liquidation is incident to a reorganization as defined in section 368 (a), shall be considered to be distributions on account of separation from service.

SEC. 403. TAXATION OF EMPLOYEE ANNUITIES.

(a) TAXABILITY OF BENEFICIARY UNDER A QUALIFIED ANNUITY PLAN.—

(1) GENERAL RULE.—Except as provided in paragraph (2), if an annuity contract is purchased by an employer for an employee under a plan with respect to which the employer's contribution is deductible under section 404 (a) (2), or if an annuity contract is purchased for an employee by an employer described in section 501 (c) (3) which is exempt from tax under section 501 (a), the employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply.

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(2) CAPITAL GAINS TREATMENT FOR CERTAIN DISTRIBUTIONS.—

(A) GENERAL RULE.—If—

(i) an annuity contract is purchased by an employer for an employee under a plan which meets the requirements of section 401 (a) (3), (4), (5), and (6);

(ii) such plan requires that refunds of contributions with respect to annuity contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan; and

(iii) the total amounts payable by reason of an employee's death or other separation from the service, or by reason of the death of an employee after the employee's separation from the service, are paid to the payee within one taxable year of the payee,

then the amount of such payments, to the extent exceeding the amount contributed by the employee (determined by applying section 72 (f)), which employee contributions shall be reduced by any amounts theretofore paid to him which were not includible in gross income, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months.

(B) DEFINITION.—For purposes of subparagraph (A), the term "total amounts" means the balance to the credit of an employee which becomes payable to the payee by reason of the employee's death or other separation from the service, or by reason of his death after separation from the service.

(b) TAXABILITY OF BENEFICIARY UNDER A NONQUALIFIED ANNUITY.—If an annuity contract purchased by an employer for an employee is not subject to subsection (a) and the employee's rights under the contract are nonforfeitable, except for failure to pay future premiums, the amount contributed by the employer for such annuity contract on or after such rights become nonforfeitable shall be included in the gross income of the employee in the year in which the amount is contributed. The employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply.

SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) GENERAL RULE.—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income) but if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

(1) PENSION TRUSTS.—In the taxable year when paid, if the contributions are paid into a pension trust, and if such taxable year

ends within or with a taxable year of the trust for which the trust is exempt under section 501 (a), in an amount determined as follows:

(A) an amount not in excess of 5 percent of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust, but such amount may be reduced for future years if found by the Secretary or his delegate upon periodical examinations at not less than 5-year intervals to be more than the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan, plus

(B) any excess over the amount allowable under subparagraph (A) necessary to provide with respect to all of the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee, as determined under regulations prescribed by the Secretary or his delegate, but if such remaining unfunded cost with respect to any 3 individuals is more than 50 percent of such remaining unfunded cost, the amount of such unfunded cost attributable to such individuals shall be distributed over a period of at least 5 taxable years, or

(C) in lieu of the amounts allowable under subparagraphs (A) and (B) above, an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Secretary or his delegate, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount not in excess of 10 percent of the cost which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included in the plan, as determined under regulations prescribed by the Secretary or his delegate, except that in no case shall a deduction be allowed for any amount (other than the normal cost) paid in after such pension or annuity credits are completely funded or purchased.

(D) Any amount paid in a taxable year in excess of the amount deductible in such year under the foregoing limitations shall be deductible in the succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year in accordance with the foregoing limitations.

(2) EMPLOYEES' ANNUITIES.—In the taxable year when paid, in an amount determined in accordance with paragraph (1), if the contributions are paid toward the purchase of retirement annuities and such purchase is a part of a plan which meets the requirements of section 401 (a) (3), (4), (5), and (6), and if refunds of premiums, if any, are applied within the current taxable year or next succeeding taxable year towards the purchase of such retirement annuities.

(3) STOCK BONUS AND PROFIT-SHARING TRUSTS.—

(A) LIMITS ON DEDUCTIBLE CONTRIBUTIONS.—In the taxable year when paid, if the contributions are paid into a stock bonus or profit-sharing trust, and if such taxable year ends within or with a taxable year of the trust with respect to which the trust

is exempt under section 501 (a), in an amount not in excess of 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit-sharing plan. If in any taxable year there is paid into the trust, or a similar trust then in effect, amounts less than the amounts deductible under the preceding sentence, the excess, or if no amount is paid, the amounts deductible, shall be carried forward and be deductible when paid in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any such succeeding taxable year shall not exceed 15 percent of the compensation otherwise paid or accrued during such succeeding taxable year to the beneficiaries under the plan. In addition, any amount paid into the trust in any taxable year in excess of the amount allowable with respect to such year under the preceding provisions of this subparagraph shall be deductible in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any one such succeeding taxable year together with the amount allowable under the first sentence of this subparagraph shall not exceed 15 percent of the compensation otherwise paid or accrued during such taxable year to the beneficiaries under the plan. The term "stock bonus or profit-sharing trust", as used in this subparagraph, shall not include any trust designed to provide benefits upon retirement and covering a period of years, if under the plan the amounts to be contributed by the employer can be determined actuarially as provided in paragraph (1). If the contributions are made to 2 or more stock bonus or profit-sharing trusts, such trusts shall be considered a single trust for purposes of applying the limitations in this subparagraph.

(B) PROFIT-SHARING PLAN OF AFFILIATED GROUP.—In the case of a profit-sharing plan, or a stock bonus plan in which contributions are determined with reference to profits, of a group of corporations which is an affiliated group within the meaning of section 1504, if any member of such affiliated group is prevented from making a contribution which it would otherwise have made under the plan, by reason of having no current or accumulated earnings or profits or because such earnings or profits are less than the contributions which it would otherwise have made, then so much of the contribution which such member was so prevented from making may be made, for the benefit of the employees of such member, by the other members of the group, to the extent of current or accumulated earnings or profits, except that such contribution by each such other member shall be limited, where the group does not file a consolidated return, to that proportion of its total current and accumulated earnings or profits remaining after adjustment for its contribution deductible without regard to this subparagraph which the total prevented contribution bears to the total current and accumulated earnings or profits of all the members of the group remaining after adjustment for all contributions deductible without regard to this subparagraph. Contributions made under the preceding sentence shall be deductible under subparagraph (A) of this paragraph by the employer making such contribution, and, for the purpose of

determining amounts which may be carried forward and deducted under the second sentence of subparagraph (A) of this paragraph in succeeding taxable years, shall be deemed to have been made by the employer on behalf of whose employees such contributions were made.

(4) TRUSTS CREATED OR ORGANIZED OUTSIDE THE UNITED STATES.—If a stock bonus, pension, or profit-sharing trust would qualify for exemption under section 501 (a) except for the fact that it is a trust created or organized outside the United States, contributions to such a trust by an employer which is a resident, or corporation, or other entity of the United States, shall be deductible under the preceding paragraphs.

(5) OTHER PLANS.—In the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

(6) TAXPAYERS ON ACCRUAL BASIS.—For purposes of paragraphs (1), (2), and (3), a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

(7) LIMIT OF DEDUCTION.—If amounts are deductible under paragraphs (1) and (3), or (2) and (3), or (1), (2), and (3), in connection with 2 or more trusts, or one or more trusts and an annuity plan, the total amount deductible in a taxable year under such trusts and plans shall not exceed 25 percent of the compensation otherwise paid or accrued during the taxable year to the persons who are the beneficiaries of the trusts or plans. In addition, any amount paid into such trust or under such annuity plans in any taxable year in excess of the amount allowable with respect to such year under the preceding provisions of this paragraph shall be deductible in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any one such succeeding taxable year together with the amount allowable under the first sentence of this paragraph shall not exceed 30 percent of the compensation otherwise paid or accrued during such taxable years to the beneficiaries under the trusts or plans. This paragraph shall not have the effect of reducing the amount otherwise deductible under paragraphs (1), (2), and (3), if no employee is a beneficiary under more than one trust, or a trust and an annuity plan.

(b) METHOD OF CONTRIBUTIONS, ETC., HAVING THE EFFECT OF A PLAN.—If there is no plan but a method of employer contributions or compensation has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, subsection (a) shall apply as if there were such a plan.

(c) CERTAIN NEGOTIATED PLANS.—If contributions are paid by an employer—

(1) under a plan under which such contributions are held in trust for the purpose of paying (either from principal or income or both) for the benefit of employees and their families and dependents

at least medical or hospital care, and pensions on retirement or death of employees; and

(2) such plan was established prior to January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which such employer is engaged,

such contributions shall not be deductible under this section nor be made nondeductible by this section, but the deductibility thereof shall be governed solely by section 162 (relating to trade or business expenses). This subsection shall have no application with respect to amounts contributed to a trust on or after any date on which such trust is qualified for exemption from tax under section 501 (a).

(d) CARRYOVER OF UNUSED DEDUCTIONS.—The amount of any unused deductions or contributions in excess of the deductible amounts for taxable years to which this part does not apply which under section 23 (p) of the Internal Revenue Code of 1939 would be allowable as deductions in later years had such section 23 (p) remained in effect, shall be allowable as deductions in taxable years to which this part applies as if such section 23 (p) were continued in effect for such years. However, the deduction under the preceding sentence shall not exceed an amount which, when added to the deduction allowable under subsection (a) for contributions made in taxable years to which this part applies, is not greater than the amount which would be deductible under subsection (a) if the contributions which give rise to the deduction under the preceding sentence were made in a taxable year to which this part applies.

PART II—MISCELLANEOUS PROVISIONS

Sec. 421. Employee stock options.

SEC. 421. EMPLOYEE STOCK OPTIONS.

(a) TREATMENT OF RESTRICTED STOCK OPTIONS.—If a share of stock is transferred to an individual pursuant to his exercise after 1949 of a restricted stock option, and no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him—

(1) no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which subsection (g) is applicable, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

This subsection and subsection (b) shall not apply unless (A) the individual, at the time he exercises the restricted stock option, is an employee of either the corporation granting such option, a parent or

subsidiary corporation of such corporation, or a corporation or a parent or subsidiary of such corporation issuing or assuming a stock option in a transaction to which subsection (g) is applicable, or (B) the option is exercised by him within 3 months after the date he ceases to be an employee of such corporations.

(b) SPECIAL RULE WHERE OPTION PRICE IS BETWEEN 85 PERCENT AND 95 PERCENT OF VALUE OF STOCK.—If no disposition of a share of stock acquired by an individual on his exercise after 1949 of a restricted stock option is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, but, at the time the restricted stock option was granted, the option price (computed under subparagraph (d) (1) (A)) was less than 95 percent of the fair market value at such time of such share, then, in the event of any disposition of such share by him, or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies—

(1) in the case of a share of stock acquired under an option qualifying under clause (i) of subparagraph (d) (1) (A), an amount equal to the amount (if any) by which the option price is exceeded by the lesser of—

(A) the fair market value of the share at the time of such disposition or death, or

(B) the fair market value of the share at the time the option was granted; or

(2) in the case of stock acquired under an option qualifying under clause (ii) of subparagraph (d) (1) (A), an amount equal to the lesser of—

(A) the excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(B) the excess of the fair market value of the share at the time the option was granted over the option price (computed as if the option had been exercised at such time).

In the case of the disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

(c) ACQUISITION OF NEW STOCK.—If stock is received by an individual in a distribution to which section 305, 354, 355, 356, or 1036, or so much of section 1031 as relates to section 1036, applies and such distribution was made with respect to stock transferred to him upon his exercise of the option, such stock shall be considered as having been transferred to him on his exercise of such option. A similar rule shall be applied in the case of a series of such distributions.

(d) DEFINITIONS.—For purposes of this section—

(1) RESTRICTED STOCK OPTION.—The term "restricted stock option" means an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent

or subsidiary corporation, to purchase stock of any of such corporations, but only if—

(A) at the time such option is granted—

(i) the option price is at least 85 percent of the fair market value at such time of the stock subject to the option, or

(ii) in case the purchase price of the stock under the option is fixed or determinable under a formula in which the only variable is the value of the stock at any time during a period of 6 months which includes the time the option is exercised, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the value of the stock at the time such option is granted; and

(B) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(C) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. This subparagraph shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option and such option either by its terms is not exercisable after the expiration of 5 years from the date such option is granted or is exercised within one year after the date of enactment of this title. For purposes of this subparagraph—

(i) such individual shall be considered as owning the stock owned, directly or indirectly, by or for his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

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

(D) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted, if such option has been granted on or after June 22, 1954.

(2) PARENT CORPORATION.—The term "parent corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(3) SUBSIDIARY CORPORATION.—The term "subsidiary corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(4) DISPOSITION.—

(A) GENERAL RULE.—Except as provided in subparagraph (B), the term "disposition" includes a sale, exchange, gift, or a transfer of legal title, but does not include—

(i) a transfer from a decedent to an estate or a transfer by bequest or inheritance;

(ii) an exchange to which section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies; or

(iii) a mere pledge or hypothecation.

(B) JOINT TENANCY.—The acquisition of a share of stock in the name of the employee and another jointly with the right of survivorship or a subsequent transfer of a share of stock into such joint ownership shall not be deemed a disposition, but a termination of such joint tenancy (except to the extent such employee acquires ownership of such stock) shall be treated as a disposition by him occurring at the time such joint tenancy is terminated.

(5) STOCKHOLDER APPROVAL.—If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval.

(6) EXERCISE BY ESTATE.—

(A) IN GENERAL.—If a restricted stock option is exercised subsequent to the death of the employee by the estate of the decedent, or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent, the provisions of this section shall apply to the same extent as if the option had been exercised by the decedent, except that—

(i) the holding period and employment requirements of subsection (a) shall not apply, and

(ii) any transfer by the estate of stock acquired shall be considered a disposition of such stock for purposes of subsection (b).

(B) DEDUCTION FOR ESTATE TAX.—If an amount is required to be included under subsection (b) in gross income of the estate of the deceased employee or of a person described in subparagraph (A), there shall be allowed to the estate or such person a deduction with respect to the estate tax attributable to the inclusion in the taxable estate of the deceased employee of the net value for estate tax purposes of the restricted stock option. For this purpose, the deduction shall be determined under section 691 (c) as if the option acquired from the deceased employee were an item of gross income in respect of the decedent under section 691 and as if the amount includible in gross income under subsection (b) of this section were an amount included in gross income under section 691 in respect of such item of gross income.

(e) MODIFICATION, EXTENSION, OR RENEWAL OF OPTION.—

(1) RULES OF APPLICATION.—For purposes of subsection (d), if the terms of any option to purchase stock are modified, extended, or renewed, the following rules shall be applied with respect to transfers of stock made on the exercise of the option after the making of such modification, extension, or renewal—

(A) such modification, extension, or renewal shall be considered as the granting of a new option,

(B) the fair market value of such stock at the time of the granting of such option shall be considered as—

(i) the fair market value of such stock on the date of the original granting of the option,

(ii) the fair market value of such stock on the date of the making of such modification, extension, or renewal, or

(iii) the fair market value of such stock at the time of the making of any intervening modification, extension, or renewal, whichever is the highest.

Subparagraph (B) shall not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months before the date of the modification, extension, or renewal, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest.

(2) DEFINITION OF MODIFICATION.—The term "modification" means any change in the terms of the option which gives the employee additional benefits under the option, but such term shall not include a change in the terms of the option—

(A) attributable to the issuance or assumption of an option under subsection (g); or

(B) to permit the option to qualify under subsection (d) (1) (B).

If an option is exercisable after the expiration of 10 years from the date such option is granted, subparagraph (B) shall not apply unless the terms of the option are also changed to make it not exercisable after the expiration of such period.

(f) EFFECT OF DISQUALIFYING DISPOSITION.—If a share of stock, acquired by an individual pursuant to his exercise of a restricted stock option, is disposed of by him within 2 years from the date of the granting of the option or within 6 months after the transfer of such share to him, then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

(g) CORPORATE REORGANIZATIONS, LIQUIDATIONS, ETC.—For purposes of this section, the term "issuing or assuming a stock option in a transaction to which subsection (g) is applicable" means a substitution of a new option for the old option, or an assumption of the old option, by an employer corporation, or a parent or subsidiary of such corporation, by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation, if—

(1) the excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than

the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(2) the new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

For purposes of this subsection, the parent-subsidiary relationship shall be determined at the time of any such transaction under this subsection.

Subchapter E—Accounting Periods and Methods of Accounting

Part I. Accounting periods.
Part II. Methods of accounting.
Part III. Adjustments.

PART I—ACCOUNTING PERIODS

Sec. 441. Period for computation of taxable income.
Sec. 442. Change of annual accounting period.
Sec. 443. Returns for a period of less than 12 months.

SEC. 441. PERIOD FOR COMPUTATION OF TAXABLE INCOME.

(a) COMPUTATION OF TAXABLE INCOME.—Taxable income shall be computed on the basis of the taxpayer's taxable year.

(b) TAXABLE YEAR.—For purposes of this subtitle, the term "taxable year" means—

(1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(2) the calendar year, if subsection (g) applies; or

(3) the period for which the return is made, if a return is made for a period of less than 12 months.

(c) ANNUAL ACCOUNTING PERIOD.—For purposes of this subtitle, the term "annual accounting period" means the annual period on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) CALENDAR YEAR.—For purposes of this subtitle, the term "calendar year" means a period of 12 months ending on December 31.

(e) FISCAL YEAR.—For purposes of this subtitle, the term "fiscal year" means a period of 12 months ending on the last day of any month other than December. In the case of any taxpayer who has made the election provided by subsection (f), the term means the annual period (varying from 52 to 53 weeks) so elected.

(f) ELECTION OF YEAR CONSISTING OF 52–53 WEEKS.—

(1) GENERAL RULE.—A taxpayer who, in keeping his books, regularly computes his income on the basis of an annual period which varies from 52 to 53 weeks and ends always on the same day of the week and ends always—

(A) on whatever date such same day of the week last occurs in a calendar month, or

(B) on whatever date such same day of the week falls which is nearest to the last day of a calendar month,

may (in accordance with the regulations prescribed under paragraph (3)) elect to compute his taxable income for purposes of this subtitle on the basis of such annual period. This paragraph shall apply to taxable years ending after the date of the enactment of this title.

(2) SPECIAL RULES FOR 52–53-WEEK YEAR.—

(A) EFFECTIVE DATES.—In any case in which the effective date or the applicability of any provision of this title is expressed in terms of taxable years beginning or ending with reference to a specified date which is the first or last day of a month, a taxable year described in paragraph (1) shall (except for purposes of the computation under section 21) be treated—

(i) as beginning with the first day of the calendar month beginning nearest to the first day of such taxable year, or

(ii) as ending with the last day of the calendar month ending nearest to the last day of such taxable year,

as the case may be.

(B) CHANGE IN ACCOUNTING PERIOD.—In the case of a change from or to a taxable year described in paragraph (1)—

(i) if such change results in a short period (within the meaning of section 443) of 359 days or more, or of less than 7 days, section 443 (b) (relating to alternative tax computation) shall not apply;

(ii) if such change results in a short period of less than 7 days, such short period shall, for purposes of this subtitle, be added to and deemed a part of the following taxable year; and

(iii) if such change results in a short period to which subsection (b) of section 443 applies, the taxable income for such short period shall be placed on an annual basis for purposes of such subsection by multiplying such income by 365 and dividing the result by the number of days in the short period, and the tax shall be the same part of the tax computed on the annual basis as the number of days in the short period is of 365 days.

(3) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as he deems necessary for the application of this subsection.

(g) NO BOOKS KEPT; NO ACCOUNTING PERIOD.—Except as provided in section 443 (relating to returns for periods of less than 12 months), the taxpayer's taxable year shall be the calendar year if—

(1) the taxpayer keeps no books;

(2) the taxpayer does not have an annual accounting period; or

(3) the taxpayer has an annual accounting period, but such period does not qualify as a fiscal year.

SEC. 442. CHANGE OF ANNUAL ACCOUNTING PERIOD.

If a taxpayer changes his annual accounting period, the new accounting period shall become the taxpayer's taxable year only if the change is approved by the Secretary or his delegate. For purposes of this subtitle, if a taxpayer to whom section 441 (g) applies adopts an annual accounting period (as defined in section 441 (c)) other than a calendar year, the taxpayer shall be treated as having changed his annual accounting period.

SEC. 443. RETURNS FOR A PERIOD OF LESS THAN 12 MONTHS.

(a) RETURNS FOR SHORT PERIOD.—A return for a period of less than 12 months (referred to in this section as "short period") shall be made under any of the following circumstances:

(1) CHANGE OF ANNUAL ACCOUNTING PERIOD.—When the taxpayer, with the approval of the Secretary or his delegate, changes his annual accounting period. In such a case, the return shall be made for the short period beginning on the day after the close of the former taxable year and ending at the close of the day before the day designated as the first day of the new taxable year.

(2) TAXPAYER NOT IN EXISTENCE FOR ENTIRE TAXABLE YEAR.—When the taxpayer is in existence during only part of what would otherwise be his taxable year.

(3) TERMINATION OF TAXABLE YEAR FOR JEOPARDY.—When the Secretary or his delegate terminates the taxpayer's taxable year under section 6851 (relating to tax in jeopardy).

(b) COMPUTATION OF TAX ON CHANGE OF ANNUAL ACCOUNTING PERIOD.—

(1) GENERAL RULE.—If a return is made under paragraph (1) of subsection (a), the taxable income for the short period shall be placed on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. The tax shall be the same part of the tax computed on the annual basis as the number of months in the short period is of 12 months.

(2) EXCEPTION.—

(A) COMPUTATION BASED ON 12-MONTH PERIOD.—If the taxpayer applies for the benefits of this paragraph and establishes the amount of his taxable income for the 12-month period described in subparagraph (B), computed as if that period were a taxable year and under the law applicable to that year, then the tax for the short period, computed under paragraph (1), shall be reduced to the greater of the following:

(i) an amount which bears the same ratio to the tax computed on the taxable income for the 12-month period as the taxable income computed on the basis of the short period bears to the taxable income for the 12-month period; or

(ii) the tax computed on the taxable income for the short period without placing the taxable income on an annual basis.

The taxpayer (other than a taxpayer to whom subparagraph (B) (ii) applies) shall compute the tax and file his return without the application of this paragraph.

(B) 12-MONTH PERIOD.—The 12-month period referred to in subparagraph (A) shall be—

(i) the period of 12 months beginning on the first day of the short period, or

(ii) the period of 12 months ending at the close of the last day of the short period, if at the end of the 12 months referred to in clause (i) the taxpayer is not in existence or (if a corporation) has theretofore disposed of substantially all of its assets.

(C) APPLICATION FOR BENEFITS.—Application for the benefits of this paragraph shall be made in such manner and at such time as the regulations prescribed under subparagraph (D) may require; except that the time so prescribed shall not be later than the time (including extensions) for filing the return for the first taxable year which ends on or after the day which is 12

months after the first day of the short period. Such application, in case the return was filed without regard to this paragraph, shall be considered a claim for credit or refund with respect to the amount by which the tax is reduced under this paragraph.

(D) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as he deems necessary for the application of this paragraph.

(c) ADJUSTMENT IN DEDUCTION FOR PERSONAL EXEMPTION.—In the case of a taxpayer other than a corporation, if a return is made for a short period by reason of subsection (a) (1) and if the tax is not computed under subsection (b) (2), then the exemptions allowed as a deduction under section 151 (and any deduction in lieu thereof) shall be reduced to amounts which bear the same ratio to the full exemptions as the number of months in the short period bears to 12.

(d) CROSS REFERENCES.—

For inapplicability of subsection (b) in computing—

(1) Accumulated earnings tax, see section 536.

(2) Personal holding company tax, see section 546.

(3) Undistributed foreign personal holding company income, see section 557.

(4) The taxable income of a regulated investment company, see section 852 (b) (2) (E).

PART II—METHODS OF ACCOUNTING

Subpart A. Methods of accounting in general.
Subpart B. Taxable year for which items of gross income included.
Subpart C. Taxable year for which deductions taken.
Subpart D. Inventories.

Subpart A—Methods of Accounting in General

Sec. 446. General rule for methods of accounting.

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) PERMISSIBLE METHODS.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) TAXPAYER ENGAGED IN MORE THAN ONE BUSINESS.—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) REQUIREMENT RESPECTING CHANGE OF ACCOUNTING METHOD.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

Subpart B—Taxable Year for Which Items of Gross Income Included

Sec. 451. General rule for taxable year of inclusion.
Sec. 452. Prepaid income.
Sec. 453. Installment method.
Sec. 454. Obligations issued at discount.

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) GENERAL RULE.—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

(b) SPECIAL RULE IN CASE OF DEATH.—In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued only by reason of the death of the taxpayer shall not be included in computing taxable income for the period in which falls the date of the taxpayer's death.

SEC. 452. PREPAID INCOME.

(a) PREPAID INCOME TO BE EARNED OVER SHORT OR INDEFINITE PERIOD.—

(1) SHORT PERIOD.—In the case of any prepaid income to which this section applies, if the liability described in subsection (e) (2) is (at the time the income is received) to end before the first day of the sixth taxable year after the taxable year in which such income is received, then such income shall be included in gross income for the taxable year in which received, and for each of the 5 succeeding taxable years, to the extent proper under the method of accounting used under section 446 in computing taxable income for such year. If the liability does not in fact end before the first day of such sixth taxable year, such income shall be included in gross income for the taxable years specified in the preceding sentence except that with the consent of the Secretary or his delegate it shall be included in gross income in such proportions, and for such taxable years, as are specified in such consent.

(2) INDEFINITE PERIOD.—In the case of any prepaid income to which this section applies, if the liability described in subsection (e) (2) is (at the time the income is received) of indefinite duration, then such income shall be included in gross income for the taxable year in which received and for each of the 5 succeeding taxable years, consistently with the principles prescribed in paragraph (1) and subsection (b), under regulations prescribed by the Secretary or his delegate. With the consent of the Secretary or his delegate the prepaid income shall be included in gross income in such proportions, and for such taxable years, as are specified in such consent.

(b) PREPAID INCOME TO BE EARNED OVER LONG PERIOD.—In the case of any prepaid income to which this section applies, if the

liability described in subsection (e) (2) is (at the time the income is received) to end after the close of the fifth taxable year after the taxable year in which such income is received, then—

(1) one-sixth of the prepaid income shall be included in gross income for the taxable year in which received, and one-sixth shall be included in gross income for each of the 5 succeeding taxable years; except that

(2) with the consent of the Secretary or his delegate, the prepaid income shall be included in gross income in such proportions, and for such taxable years, as are specified in such consent.

(c) WHERE TAXPAYER'S LIABILITY CEASES.—In the case of any prepaid income to which this section applies—

(1) If the liability described in subsection (e) (2) ends, then so much of such income as was not includible in gross income under subsections (a) and (b) for preceding taxable years shall be included in gross income for the taxable year in which the liability ends.

(2) If the taxpayer dies or ceases to exist, then so much of such income as was not includible in gross income under subsections (a) and (b) for preceding taxable years shall be included in gross income for the taxable year in which such death, or such cessation of existence, occurs.

(d) PREPAID INCOME TO WHICH THIS SECTION APPLIES.—

(1) ELECTION OF BENEFITS.—This section shall apply to prepaid income if and only if the taxpayer makes an election under this section with respect to the trade or business in connection with which such income is received. The election shall be made in such manner as the Secretary or his delegate may by regulations prescribe. No election may be made with respect to a trade or business if in computing taxable income the cash receipts and disbursements method of accounting is used with respect to such trade or business.

(2) SCOPE OF ELECTION.—An election made under this section shall apply to all prepaid income received in connection with the trade or business with respect to which the taxpayer has made the election; except that the taxpayer may, to the extent permitted under regulations prescribed by the Secretary or his delegate, include in gross income for the taxable year of receipt the entire amount of any prepaid income if the liability from which it arose is to end within 12 months after the date of receipt. An election made under this section shall not apply to any prepaid income received before the first taxable year for which the election is made.

(3) WHEN ELECTION MAY BE MADE.—

(A) WITHOUT CONSENT.—A taxpayer may, without the consent of the Secretary or his delegate, make an election under this section for his first taxable year (i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and (ii) in which he receives prepaid income in the trade or business. Such an election shall be made not later than the time prescribed by this subtitle for filing the return for such year (including extensions thereof).

(B) WITH CONSENT.—A taxpayer may, with the consent of the Secretary or his delegate, make an election under this section at any time.

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(e) DEFINITIONS.—For purposes of this section—

(1) PREPAID INCOME.—The term "prepaid income" means any amount (includible in gross income) which is received in connection with, and is directly attributable to, a liability which extends beyond the close of the taxable year in which such amount is received. Such term does not include any income treated as gain from the sale or other disposition of a capital asset.

(2) LIABILITY TO RENDER SERVICES, ETC.—The term "liability" means a liability to render services, furnish goods or other property, or allow the use of property.

(3) RECEIPT OF PREPAID INCOME.—Prepaid income shall be treated as received during the taxable year for which it is includible in gross income under section 451 (without regard to this section).

SEC. 453. INSTALLMENT METHOD.

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

(b) SALES OF REALTY AND CASUAL SALES OF PERSONALTY.—

(1) GENERAL RULE.—Income from—

(A) a sale or other disposition of real property, or

(B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000,

may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a).

(2) LIMITATION.—Paragraph (1) shall apply—

(A) In the case of a sale or other disposition during a taxable year beginning after December 31, 1953 (whether or not such taxable year ends after the date of enactment of this title), only if in the taxable year of the sale or other disposition—

(i) there are no payments, or

(ii) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price.

(B) In the case of a sale or other disposition during a taxable year beginning before January 1, 1954, only if the income was (by reason of section 44 (b) of the Internal Revenue Code of 1939) returnable on the basis and in the manner prescribed in section 44 (a) of such code.

(c) CHANGE FROM ACCRUAL TO INSTALLMENT BASIS.—

(1) GENERAL RULE.—If a taxpayer entitled to the benefits of subsection (a) elects for any taxable year to report his taxable income on the installment basis, then in computing his taxable income for such year (referred to in this subsection as "year of change") or for any subsequent year—

(A) installment payments actually received during any such year on account of sales or other dispositions of property made

in any taxable year before the year of change shall not be excluded; but

(B) the tax imposed by this chapter for any taxable year (referred to in this subsection as "adjustment year") beginning after December 31, 1953, shall be reduced by the adjustment computed under paragraph (2).

(2) ADJUSTMENT IN TAX FOR AMOUNTS PREVIOUSLY TAXED.—In determining the adjustment referred to in paragraph (1) (B), first determine, for each taxable year before the year of change, the amount which equals the lesser of—

(A) the portion of the tax for such prior taxable year which is attributable to the gross profit which was included in gross income for such prior taxable year, and which by reason of paragraph (1) (A) is includible in gross income for the taxable year, or

(B) the portion of the tax for the adjustment year which is attributable to the gross profit described in subparagraph (A).

The adjustment referred to in paragraph (1) (B) for the adjustment year is the sum of the amounts determined under the preceding sentence.

(3) RULE FOR APPLYING PARAGRAPH (2).—For purposes of paragraph (2), the portion of the tax for a prior taxable year, or for the adjustment year, which is attributable to the gross profit described in such paragraph is that amount which bears the same ratio to the tax imposed by this chapter (or by the corresponding provisions of prior revenue laws) for such taxable year (computed without regard to paragraph (2)) as the gross profit described in such paragraph bears to the gross income for such taxable year. For purposes of the preceding sentence, the provisions of chapter 1 (other than of subchapter D, relating to excess profits tax, and of subchapter E, relating to self-employment income) of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(d) GAIN OR LOSS ON DISPOSITION OF INSTALLMENT OBLIGATIONS.—

(1) GENERAL RULE.—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 distribution, transmission, or disposition, in the case 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.

(2) BASIS OF OBLIGATION.—The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

(3) SPECIAL RULE FOR TRANSMISSION AT DEATH.—Except as provided in section 691 (relating to recipients of income in respect of

decedents), this subsection shall not apply to the transmission of installment obligations at death.

(4) EFFECT OF DISTRIBUTION IN CERTAIN LIQUIDATIONS.—

(A) LIQUIDATIONS TO WHICH SECTION 332 APPLIES.—If—

(i) an installment obligation is distributed by one corporation to another corporation in the course of a liquidation, and

(ii) under section 332 (relating to complete liquidations of subsidiaries) no gain or loss with respect to the receipt of such obligation is recognized in the case of the recipient corporation,

then no gain or loss with respect to the distribution of such obligation shall be recognized in the case of the distributing corporation.

(B) LIQUIDATIONS TO WHICH SECTION 337 APPLIES.—If—

(i) an installment obligation is distributed by a corporation in the course of a liquidation, and

(ii) under section 337 (relating to gain or loss on sales or exchanges in connection with certain liquidations) no gain or loss would have been recognized to the corporation if the corporation had sold or exchanged such installment obligation on the day of such distribution,

then no gain or loss shall be recognized to such corporation by reason of such distribution.

SEC. 454. OBLIGATIONS ISSUED AT DISCOUNT.

(a) NON-INTEREST-BEARING OBLIGATIONS ISSUED AT A DISCOUNT.—If, in the case of a taxpayer owning any non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (c), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his taxable income) constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year, treat such increase as income received in such taxable year. If any such election is made with respect to any such obligation, it shall apply also to all such obligations owned by the taxpayer at the beginning of the first taxable year to which it applies and to all such obligations thereafter acquired by him and shall be binding for all subsequent taxable years, unless on application by the taxpayer the Secretary or his delegate permits him, subject to such conditions as the Secretary or his delegate deems necessary, to change to a different method. In the case of any such obligations owned by the taxpayer at the beginning of the first taxable year to which his election applies, the increase in the redemption price of such obligations occurring between the date of acquisition (or, in the case of an obligation described in paragraph (2) of subsection (c), the date of acquisition of the series E bond involved) and the first day of such taxable year shall also be treated as income received in such taxable year.

(b) SHORT-TERM OBLIGATIONS ISSUED ON DISCOUNT BASIS.—In the case of any obligation—

(1) of the United States; or

(2) 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,

which is issued on a discount basis and payable without interest at a fixed maturity date not exceeding 1 year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

(c) MATURED UNITED STATES SAVINGS BONDS.—In the case of a taxpayer who—

(1) holds a series E United States savings bond at the date of maturity, and

(2) pursuant to regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than 10 years from the date of maturity of such series E bond,

the increase in redemption value (to the extent not previously includible in gross income) in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. This subsection shall not apply to a corporation, and shall not apply in the case of any taxable year for which the taxpayer's taxable income is computed under an accrual method of accounting or for which an election made by the taxpayer under subsection (a) applies.

Subpart C—Taxable Year for Which Deductions Taken

Sec. 461. General rule for taxable year of deduction.
Sec. 462. Reserves for estimated expenses, etc.

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) GENERAL RULE.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

(b) SPECIAL RULE IN CASE OF DEATH.—In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued as a deduction or credit only by reason of the death of the taxpayer shall not be allowed in computing taxable income for the period in which falls the date of the taxpayer's death.

(c) ACCRUAL OF REAL PROPERTY TAXES.—

(1) IN GENERAL.—If the taxable income is computed under an accrual method of accounting, then, at the election of the taxpayer, any real property tax which is related to a definite period of time shall be accrued ratably over that period.

(2) SPECIAL RULES.—Paragraph (1) shall not apply to any real property tax, to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 for a taxable year which began before January 1, 1954. In the case of any real property tax which would, but for this subsection, be allowable as a deduction for the first taxable year of the taxpayer which begins after December 31, 1953, then, to the extent that such tax is related to any period before the first day of such first taxable year, the tax shall be allowable as a deduction for such first taxable year.

(3) WHEN ELECTION MAY BE MADE.—

(A) WITHOUT CONSENT.—A taxpayer may, without the consent of the Secretary or his delegate, make an election under this subsection for his first taxable year which begins after December 31, 1953, and ends after the date of enactment of this title in which the taxpayer incurs real property taxes. Such an election shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof).

(B) WITH CONSENT.—A taxpayer may, with the consent of the Secretary or his delegate, make an election under this subsection at any time.

SEC. 462. RESERVES FOR ESTIMATED EXPENSES, ETC.

(a) GENERAL RULE.—In computing taxable income for the taxable year, there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses to which this section applies.

(b) ADJUSTMENTS WHERE RESERVE BECOMES EXCESSIVE.—If it is determined that the amount of any reserve for estimated expenses to which this section applies is (as of the close of the taxable year) excessive, then (under regulations prescribed by the Secretary or his delegate) such excess shall be taken into account in computing taxable income for the taxable year.

(c) ESTIMATED EXPENSES TO WHICH THIS SECTION APPLIES.—

(1) ELECTION OF BENEFITS.—This section shall apply to estimated expenses if and only if the taxpayer makes an election under this section with respect to the trade or business to which such expenses are attributable. The election shall be made in such manner as the Secretary or his delegate may by regulations prescribe. No election may be made with respect to a trade or business if in computing taxable income the cash receipts and disbursements method of accounting is used with respect to such trade or business.

(2) SCOPE OF ELECTION.—An election made under this section shall apply to all estimated expenses attributable to the trade or business.

(3) WHEN ELECTION MAY BE MADE.—

(A) WITHOUT CONSENT.—A taxpayer may, without the consent of the Secretary or his delegate, make an election under this section for his first taxable year (i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and (ii) for which there are estimated expenses attributable to the trade or business. Such an election shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof).

(B) WITH CONSENT.—A taxpayer may, with the consent of the Secretary or his delegate, make an election under this section at any time.

(d) ESTIMATED EXPENSE DEFINED.—

(1) GENERAL RULE.—For purposes of this section, the term "estimated expense" means a deduction allowable by this subtitle—

(A) part or all of which would (but for this section) be required to be taken into account for a subsequent taxable year;

(B) which is attributable to the income of the taxable year or prior taxable years for which an election under this section is in effect; and

(C) which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy.

(2) EXCEPTIONS.—The term "estimated expense" does not include—

(A) any deduction attributable to income taken into account in computing taxable income for taxable years preceding the first taxable year for which the election is made;

(B) any deduction attributable to prepaid income to which section 452 applies by reason of an election made under such section by the taxpayer; or

(C) any deduction allowable under section 166 (relating to bad debts).

(e) SPECIAL RULE FOR DEDUCTIONS ATTRIBUTABLE TO PERIOD BEFORE ELECTION.—Any deduction attributable to income taken into account in computing taxable income for taxable years preceding the first taxable year for which the election is made shall be allowable in the same manner and to the same extent as if this section had not been enacted.

Subpart D—Inventories

Sec. 471. General rule for inventories.
Sec. 472. Last-in, first-out inventories.

SEC. 471. GENERAL RULE FOR INVENTORIES.

Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

SEC. 472. LAST-IN, FIRST-OUT INVENTORIES.

(a) AUTHORIZATION.—A taxpayer may use the method provided in subsection (b) (whether or not such method has been prescribed under section 471) in inventorying goods specified in an application to use such method filed at such time and in such manner as the Secretary or his delegate may prescribe. The change to, and the use of, such method shall be in accordance with such regulations as the Secretary or his delegate may prescribe as necessary in order that the use of such method may clearly reflect income.

(b) METHOD APPLICABLE.—In inventorying goods specified in the application described in subsection (a), the taxpayer shall:

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

(2) Inventory them at cost; and

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

(c) CONDITION.—Subsection (a) shall apply only if the taxpayer establishes to the satisfaction of the Secretary or his delegate that the taxpayer has used no procedure other than that specified in paragraphs (1) and (3) of subsection (b) in inventorying such goods to ascertain the income, profit, or loss of the first taxable year for which the method described in subsection (b) is to be used, for the purpose of a report or statement covering such taxable year—

(1) to shareholders, partners, or other proprietors, or to beneficiaries, or

(2) for credit purposes.

(d) PRECEDING CLOSING INVENTORY.—In determining income for the taxable year preceding the taxable year for which the method described in subsection (b) is first used, the closing inventory of such preceding year of the goods specified in the application referred to in subsection (a) shall be at cost.

(e) SUBSEQUENT INVENTORIES.—If a taxpayer, having complied with subsection (a), uses the method described in subsection (b) for any taxable year, then such method shall be used in all subsequent taxable years unless—

(1) with the approval of the Secretary or his delegate a change to a different method is authorized; or,

(2) the Secretary or his delegate determines that the taxpayer has used for any such subsequent taxable year some procedure other than that specified in paragraph (1) of subsection (b) in inventorying the goods specified in the application to ascertain the income, profit, or loss of such subsequent taxable year for the purpose of a report or statement covering such taxable year (A) to shareholders, partners, or other proprietors, or beneficiaries, or (B) for credit purposes; and requires a change to a method different from that prescribed in subsection (b) beginning with such subsequent taxable year or any taxable year thereafter.

If paragraph (1) or (2) of this subsection applies, the change to, and the use of, the different method shall be in accordance with such regulations as the Secretary or his delegate may prescribe as necessary in order that the use of such method may clearly reflect income.

(f) CROSS REFERENCE.—

For provisions relating to involuntary liquidation and replacement of LIFO inventories, see section 1321.

PART III—ADJUSTMENTS

Sec. 481. Adjustments required by changes in method of accounting.
Sec. 482. Allocation of income and deductions among taxpayers.

SEC. 481. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING.

(a) GENERAL RULE.—In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—

(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in

order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply.

(b) LIMITATION ON TAX WHERE ADJUSTMENTS ARE SUBSTANTIAL.—

(1) THREE YEAR ALLOCATION.—If—

(A) the method of accounting from which the change is made was used by the taxpayer in computing his taxable income for the 2 taxable years preceding the year of the change, and

(B) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a) (2) exceeds $3,000,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the aggregate of the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if one-third of such increase were included in taxable income for the year of the change and one-third of such increase were included for each of the 2 preceding taxable years.

(2) ALLOCATION UNDER NEW METHOD OF ACCOUNTING.—If—

(A) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a) (2) exceeds $3,000, and

(B) the taxpayer establishes his taxable income (under the new method of accounting) for one or more taxable years consecutively preceding the taxable year of the change for which the taxpayer in computing taxable income used the method of accounting from which the change is made,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the net increase in the taxes under this chapter which would result if the adjustments required by subsection (a) (2) were allocated to the taxable year or years specified in subparagraph (B) to which they are properly allocable under the new method of accounting and the balance of the adjustments required by subsection (a) (2) was allocated to the taxable year of the change.

(3) SPECIAL RULES FOR COMPUTATIONS UNDER PARAGRAPHS (1) AND (2).—For purposes of this subsection—

(A) There shall be taken into account the increase or decrease in tax for any taxable year preceding the year of the change to which no adjustment is allocated under paragraph (2) but which is affected by a net operating loss (as defined in section 172) or by a capital loss carryover (as defined in section 1212), determined with reference to taxable years with respect to which adjustments under paragraph (2) are allocated.

(B) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning of section 1314 (a)) for such year.

(C) In applying section 7807 (b) (1), the provisions of chapter 1 (other than subchapter E, relating to self-employment income)

and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(c) ADJUSTMENTS UNDER REGULATIONS.—In the case of any change described in subsection (a), the taxpayer may, in such manner and subject to such conditions as the Secretary or his delegate may by regulations prescribe, take the adjustments required by subsection (a) (2) into account in computing the tax imposed by this chapter for the taxable year or years permitted under such regulations.

(d) EXCEPTION FOR CHANGE TO INSTALLMENT BASIS.—This section shall not apply to a change to which section 453 (relating to change to installment method) applies.

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Subchapter F—Exempt Organizations

Part I. General rule.
Part II. Taxation of business income of certain exempt organizations.
Part III. Farmers' cooperatives.
Part IV. Shipowners' protection and indemnity associations.

PART I—GENERAL RULE

Sec. 501. Exemption from tax on corporations, certain trusts, etc.
Sec. 502. Feeder organizations.
Sec. 503. Requirements for exemption.
Sec. 504. Denial of exemption.

SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, 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, 503, or 504.

(b) TAX ON UNRELATED BUSINESS INCOME.—An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in part II of this subchapter (relating to tax on unrelated income), but, notwithstanding part II, shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

(c) LIST OF EXEMPT ORGANIZATIONS.—The following organizations are referred to in subsection (a):

(1) Corporations organized under Act of Congress, if such corporations are instrumentalities of the United States and if, under such Act, as amended and supplemented, such corporations are exempt from Federal income taxes.

(2) 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 under this section.

(3) Corporations, and any community chest, fund, or foundation, 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, no part of the net earnings of which inures to the benefit of any private shareholder 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.

(4) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular

municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

(5) Labor, agricultural, or horticultural organizations.

(6) Business leagues, chambers of commerce, real-estate boards, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(7) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder.

(8) 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.

(9) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents, if—

(A) no part of their net earnings inures (other than through such payments) to the benefit of any private shareholder or individual, and

(B) 85 percent or more of the income consists of amounts collected from members and amounts contributed to the association by the employer of the members for the sole purpose of making such payments and meeting expenses.

(10) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or their designated beneficiaries, if—

(A) admission to membership in such association is limited to individuals who are officers or employees of the United States Government, and

(B) no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

(11) Teachers' retirement fund associations of a purely local character, if—

(A) no part of their net earnings inures (other than through payment of retirement benefits) to the benefit of any private shareholder or individual, and

(B) the income consists solely of amounts received from public taxation, amounts received from assessments on the teaching salaries of members, and income in respect of investments.

(12) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

(13) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit;

and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(14) Credit unions without capital stock organized and operated for mutual purposes and without profit; and corporations or associations without capital stock organized before September 1, 1951, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of, shares or deposits in—

(A) domestic building and loan associations,

(B) cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(C) mutual savings banks not having capital stock represented by shares.

(15) Mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000.

(16) Corporations organized by an association subject to part III 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.

(d) Religious and Apostolic Organizations.—The following organizations are referred to in subsection (a): Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

(e) Cross Reference.—

For nonexemption of Communist-controlled organizations, see section 11 (b) of the Internal Security Act of 1950 (64 Stat. 997; 50 U. S. C. 790 (b)).

SEC. 502. FEEDER ORGANIZATIONS.

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section 501 from taxation. For purposes of this section, the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

SEC. 503. REQUIREMENTS FOR EXEMPTION.

(a) DENIAL OF EXEMPTION TO ORGANIZATIONS ENGAGED IN PROHIBITED TRANSACTIONS.—

(1) GENERAL RULE.—An organization described in section 501 (c) (3) which is subject to the provisions of this section shall not be exempt from taxation under section 501 (a) if it has engaged in a prohibited transaction after July 1, 1950; and an organization described in section 401 (a) which is subject to the provisions of this section shall not be exempt from taxation under section 501 (a) if it has engaged in a prohibited transaction after March 1, 1954.

(2) TAXABLE YEARS AFFECTED.—An organization described in section 501 (c) (3) or section 401 (a) 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.

(b) ORGANIZATIONS TO WHICH SECTION APPLIES.—This section shall apply to any organization described in section 501 (c) (3) or section 401 (a) except—

(1) a religious organization (other than a trust);

(2) 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;

(3) 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;

(4) 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

(5) 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.

(c) 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.

(d) FUTURE STATUS OF ORGANIZATIONS DENIED EXEMPTION.—Any organization described in section 501 (c) (3) or section 401 (a) 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.

(e) DISALLOWANCE OF CERTAIN CHARITABLE, ETC., DEDUCTIONS.—No gift or bequest for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals), otherwise allowable as a deduction under section 170, 642 (c), 545 (b) (2), 2055, 2106 (a) (2), or 2522, shall be allowed as a deduction if made to an organization described in section 501 (c) (3) which, in the taxable year of the organization in which the gift or bequest is made, is not exempt under section 501 (a) by reason of this section. With respect to any taxable year of the organization for which the organization is not exempt pursuant to subsection (a) by reason of having engaged in a prohibited transaction with the purpose of diverting the corpus or income of such organization from its exempt purposes and such transaction involved a substantial part of such corpus or income, and which taxable year is the same, or prior to the, taxable year of the organization in which such transaction occurred, such deduction shall be disallowed the donor only if such donor or (if such donor is an individual) any member

of his family (as defined in section 267 (c) (4)) was a party to such prohibited transaction.

(f) DEFINITION.—For purposes of this section, the term "gift or bequest" means any gift, contribution, bequest, devise, legacy, or transfer.

(g) SPECIAL RULE FOR LOANS.—For purposes of the application of subsection (c) (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. 504. DENIAL OF EXEMPTION.

(a) GENERAL RULE.—In the case of any organization described in section 501 (c) (3) to which section 503 is applicable, exemption under section 501 shall be denied for the taxable year if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3); or

(2) are used to a substantial degree for purposes or functions other than those constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3); or

(3) are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3).

Paragraph (1) shall not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. In the case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, paragraph (1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

(b) CROSS REFERENCES.—

For limitation on charitable contributions in case of unreasonable accumulations by certain trusts, see section 681 (c) (2).

PART II—TAXATION OF BUSINESS INCOME OF CERTAIN EXEMPT ORGANIZATIONS

Sec. 511. Imposition of tax on unrelated business income of charitable organizations, etc.
Sec. 512. Unrelated business taxable income.
Sec. 513. Unrelated trade or business.
Sec. 514. Business leases.
Sec. 515. Taxes of foreign countries and possessions of the United States.

SEC. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) CHARITABLE, ETC., ORGANIZATIONS TAXABLE AT CORPORATION RATES.—

(1) IMPOSITION OF TAX.—There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a normal tax and a surtax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

(2) ORGANIZATIONS SUBJECT TO TAX.—

(A) ORGANIZATIONS DESCRIBED IN SECTION 501 (c) (2), (3), (5), AND (6), AND SECTION 401 (a).—The taxes imposed by paragraph (1) shall apply in the case of any organization (other than a church, a convention or association of churches, or a trust described in subsection (b)) which is exempt, except as provided in this part, from taxation under this subtitle by reason of section 401 (a) or of paragraph (3), (5), or (6) of section 501 (c). Such taxes shall also apply in the case of a corporation described in section 501 (c) (2) if the income is payable to an organization which itself is subject to the taxes imposed by paragraph (1) or to a church or to a convention or association of churches.

(B) STATE COLLEGES AND UNIVERSITIES.—The taxes imposed by paragraph (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. Such taxes shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

(b) TAX ON CHARITABLE, ETC., TRUSTS.—

(1) IMPOSITION OF TAX.—There is hereby imposed for each taxable year on the unrelated business taxable income of every trust described in paragraph (2) a tax computed as provided in section 1. In making such computation for purposes of this section, the term "taxable income" as used in section 1 shall be read as "unrelated business taxable income" as defined in section 512.

(2) CHARITABLE, ETC., TRUSTS SUBJECT TO TAX.—The tax imposed by paragraph (1) shall apply in the case of any trust which is exempt, except as provided in this part, from taxation under this subtitle by reason of section 501 (c) (3) or section 401 (a) and which, if it were not for such exemption, would be subject to subchapter J

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(sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents).

(c) EFFECTIVE DATE.—The tax imposed by this section shall apply, in the case of a trust described in section 401 (a), only for taxable years beginning after June 30, 1954.

SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.

(a) DEFINITION.—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 by this chapter which are directly connected with the carrying on of such trade or business, both computed with the exceptions, additions, and limitations provided in subsection (b). In the case of an organization described in section 511 which is a foreign organization, the unrelated business taxable income shall be its unrelated business taxable income derived from sources within the United States determined under subchapter N (sec. 861 and following, relating to tax based on income from sources within or without the United States).

(b) EXCEPTIONS, ADDITIONS, AND LIMITATIONS.—The exceptions, additions, and limitations applicable in determining unrelated business taxable income are the following:

(1) There shall be excluded all dividends, interest, and annuities, and all deductions directly connected with such income.

(2) 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.

(3) There shall be excluded all rents from real property (including personal property leased with the real property), and all deductions directly connected with such rents.

(4) Notwithstanding paragraph (3), in the case of a business lease (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514 (a) (1), and there shall be allowed, as a deduction, the amount ascertained under section 514 (a) (2).

(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than—

(A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(B) property held primarily for sale to customers in the ordinary course of the trade or business.

This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

(6) The net operating loss deduction provided in section 172 shall be allowed, except that—

(A) the net operating loss for any taxable year, the amount of the net operating loss carryback or carryover to any taxable year, and the net operating loss deduction for any taxable year shall be determined under section 172 without taking into account

any amount of income or deduction which is excluded under this part in computing the unrelated business taxable income; and

(B) the terms "preceding taxable year" and "preceding taxable years" as used in section 172 shall not include any taxable year for which the organization was not subject to the provisions of this part.

(7) There shall be excluded all income derived from research for (A) the United States, or any of its agencies or instrumentalities, or (B) any State or political subdivision thereof; and there shall be excluded all deductions directly connected with such income.

(8) In the case of a college, university, or hospital, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(9) In the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(10) In the case of any organization described in section 511 (a), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), but shall not exceed 5 percent of the unrelated business taxable income computed without the benefit of this paragraph.

(11) In the case of any trust described in section 511 (b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170 (b) (1) (A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

(12) There shall be allowed a specific deduction of $1,000.

(c) Special Rules Applicable to Partnerships.—If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income. If the taxable year of the organization is different from that of the partnership, the amounts to be so included or deducted in computing the unrelated business taxable income shall be based upon the income and deductions of the partnership for any taxable year of the partnership ending within or with the taxable year of the organization.

SEC. 513. UNRELATED TRADE OR BUSINESS.

(a) GENERAL RULE.—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 (or, in the case of an organization described in section 511 (a) (2) (B), to the exercise or performance of any purpose or function described in section 501 (c) (3)), except that such term does not include any trade or business—

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) which is carried on, in the case of an organization described in section 501 (c) (3) or in the case of a college or university described in section 511 (a) (2) (B), by the organization primarily for the convenience of its members, students, patients, officers, or employees; or

(3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

(b) SPECIAL RULE FOR TRUSTS.—The term "unrelated trade or business" means, in the case of—

(1) a trust computing its unrelated business taxable income under section 512 for purposes of section 681; or

(2) a trust described in section 401 (a) which is exempt from tax under section 501 (a);

any trade or business regularly carried on by such trust or by a partnership of which it is a member.

(c) SPECIAL RULE FOR CERTAIN PUBLISHING BUSINESSES.—If a publishing business carried on by an organization during a taxable year beginning before January 1, 1953, is, without regard to this subsection, an unrelated trade or business, but before the beginning of the third succeeding taxable year the business is carried on by it (or by a successor who acquired such business in a liquidation which would have constituted a tax-free exchange under section 112 (b) (6) of the Internal Revenue Code of 1939) in such manner that the conduct thereof is substantially related to the exercise or performance by such organization (or such successor) of its educational or other purpose or function described in section 501 (c) (3), such publishing business shall not be considered, for the taxable year, as an unrelated trade or business.

SEC. 514. BUSINESS LEASES.

(a) BUSINESS LEASE RENTS AND DEDUCTIONS.—In computing under section 512 the unrelated business taxable income for any taxable year—

(1) PERCENTAGE OF RENTS TAKEN INTO ACCOUNT.—There shall be included with respect to each business lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 percent) of the total rents derived during the taxable year under such lease

as (A) the business lease indebtedness, at the close of the taxable year, with respect to the premises covered by such lease is of (B) the adjusted basis, at the close of the taxable year, of such premises.

(2) PERCENTAGE OF DEDUCTIONS TAKEN INTO ACCOUNT.—There shall be allowed with respect to each business lease, as a deduction to be taken into account in computing unrelated business taxable income, an amount determined by applying the percentage derived under paragraph (1) to the sum determined under paragraph (3).

(3) DEDUCTIONS ALLOWABLE.—The sum referred to in paragraph (2) is the sum of the following deductions allowable under this chapter:

(A) Taxes and other expenses paid or accrued during the taxable year on or with respect to the real property subject to the business lease.

(B) Interest paid or accrued during the taxable year on the business lease indebtedness.

(C) A reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of the real property subject to such lease.

Where only a portion of the real property is subject to the business lease, there shall be taken into account under subparagraphs (A), (B), and (C) only those amounts which are properly allocable to the premises covered by such lease.

(b) DEFINITION OF BUSINESS LEASE.—

(1) GENERAL RULE.—For purposes of this section, the term "business lease" means a lease for a term of more than 5 years of real property by an organization (or by a partnership of which it is a member), if at the close of the lessor's taxable year there is a business lease indebtedness (as defined in subsection (c)) with respect to such property.

(2) SPECIAL RULES FOR APPLYING PARAGRAPH (1).—For purposes of paragraph (1)—

(A) In computing the term of a lease which contains an option for renewal or extension, the term of such lease shall be considered as including any period for which such option may be exercised; and the term of any lease made pursuant to an exercise of such option shall include the period during which the prior lease was in effect. If real property is acquired subject to a lease, the term of such lease shall be considered to begin on the date of such acquisition.

(B) If the property has been occupied by the same lessee for a total period of more than 5 years commencing not earlier than the date of acquisition of the property by the organization or trust (whether such occupancy is under one or more leases, renewals, extensions, or continuations thereof), the occupancy of such lessee shall be considered to be under a lease for a term of more than 5 years within the meaning of paragraph (1). However, subsection (a) shall apply in the case of a tenancy described in this subparagraph (and not within subparagraph (A)) only with respect to the sixth and succeeding years of occupancy by the same lessee. For purposes of this subparagraph, the term "same lessee" shall include any lessee of the

property whose relationship with a lessee of the same property is such that losses in respect of sales or exchanges of property between the 2 lessees would be disallowed under section 267 (a).

(3) EXCEPTIONS.—

(A) No lease shall be considered a business lease if—

(i) such lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents 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, or

(ii) the lease is of premises in a building primarily designed for occupancy, and occupied, by the organization.

(B) If a lease for more than 5 years to a tenant is for only a portion of the real property, and space in the real property is rented during the taxable year under a lease for not more than 5 years to any other tenant of the organization, leases of the real property for more than 5 years shall be considered as business leases during the taxable year only if—

(i) the rents derived from the real property during the taxable year under leases for more than 5 years (not including, as a lease for more than 5 years, an occupancy which is considered as such a lease by reason of paragraph (2) (B)) represent 50 percent or more of the total rents derived during the taxable year from the real property; or the area of the premises occupied under leases for more than 5 years (not including, as a lease for more than 5 years, an occupancy which is considered as such a lease by reason of paragraph (2) (B)) represents, at any time during the taxable year, 50 percent or more of the total area of the real property rented at such time; or

(ii) the rent derived from the real property during the taxable year from any tenant under a lease for more than 5 years (including as a lease for more than 5 years an occupancy which is considered as such a lease by reason of paragraph (2) (B)), or from a group of tenants (under such leases) who are either members of an affiliated group (as defined in section 1504) or partners, represents more than 10 percent of the total rents derived during the taxable year from such property; or the area of the premises occupied by any one such tenant, or by any such group of tenants, represents at any time during the taxable year more than 10 percent of the total area of the real property rented at such time.

In the application of clause (i), if during the last half of the term of a lease a new lease is made to take effect after the expiration of such lease, the unexpired portion of such lease on the date the second lease is made shall not be treated as a part of the term of the second lease.

(c) BUSINESS LEASE INDEBTEDNESS.—

(1) GENERAL RULE.—The term "business lease indebtedness" means, with respect to any real property leased for a term of more than 5 years, the unpaid amount of—

(A) the indebtedness incurred by the lessor in acquiring or improving such property;

(B) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(C) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

(2) PROPERTY ACQUIRED SUBJECT TO MORTGAGE, ETC.—Where real property is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered (whether the acquisition was by gift, devise, or purchase) as an indebtedness of the lessor incurred in acquiring such property even though the lessor did not assume or agree to pay such indebtedness, except that where real property was acquired by gift, bequest, or devise before July 1, 1950, subject to a mortgage or other similar lien, the amount of such mortgage or other similar lien shall not be considered as an indebtedness of the lessor incurred in acquiring such property.

(3) CERTAIN PROPERTY ACQUIRED BY GIFT, ETC.—Where real property was acquired by gift, bequest, or devise before July 1, 1950, subject to a lease requiring improvements in such property on the happening of stated contingencies, indebtedness incurred in improving such property in accordance with the terms of such lease shall not be considered as an indebtedness for purposes of this subsection.

(4) CERTAIN CORPORATIONS DESCRIBED IN SECTION 501 (c) (2).—In the case of a corporation described in section 501 (c) (2), all of the stock of which was acquired before July 1, 1950, by an organization described in paragraph (3), (5), or (6) of section 501 (c) (and more than one-third of such stock was acquired by such organization by gift or bequest), any indebtedness incurred by such corporation before July 1, 1950, and any indebtedness incurred by such corporation on or after such date in improving real property in accordance with the terms of a lease entered into before such date, shall not be considered as an indebtedness with respect to such corporation or such organization for purposes of this subsection.

(5) CERTAIN TRUSTS DESCRIBED IN SECTION 401 (a).—In the case of a trust described in section 401 (a), or in the case of a corporation described in section 501 (c) (2) all of the stock of which was acquired prior to March 1, 1954, by a trust described in section 401 (a), any indebtedness incurred by such trust or such corporation before March 1, 1954, in connection with real property which is leased before March 1, 1954, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness with respect to such trust or such corporation for purposes of this subsection.

(6) BUSINESS LEASE ON PORTION OF PROPERTY.—In determining the amount of the business lease indebtedness where only a portion

of the real property is subject to a business lease, proper allocation to the premises covered by such lease shall be made of the indebtedness incurred by the lessor with respect to the real property.

(7) SPECIAL RULE APPLICABLE TO TRUSTS DESCRIBED IN SECTION 401 (a).—In the application of paragraph (1), if a trust described in section 401 (a) forming part of a stock bonus, pension, or profit-sharing plan of an employer lends any money to another trust described in section 401 (a) forming part of a stock bonus, pension, or profit-sharing plan of the same employer, such loan shall not be treated as an indebtedness of the borrowing trust, except to the extent that the loaning trust—

(A) incurs any indebtedness in order to make such loan;

(B) incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(C) incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

(d) PERSONAL PROPERTY LEASED WITH REAL PROPERTY.—For purposes of this section, the term "real property" and the term "premises" include personal property of the lessor leased by it to a lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate.

SEC. 515. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF THE UNITED STATES.

The amount of taxes imposed by foreign countries and possessions of the United States shall be allowed as a credit against the tax of an organization subject to the tax imposed by section 511 to the extent provided in section 901; and in the case of the tax imposed by section 511, the term "taxable income" as used in section 901 shall be read as "unrelated business taxable income".

PART III—FARMERS' COOPERATIVES

Sec. 521. Exemption of farmers' cooperatives from tax.
Sec. 522. Tax on farmers' cooperatives.

SEC. 521. EXEMPTION OF FARMERS' COOPERATIVES FROM TAX.

(a) EXEMPTION FROM TAX.—A farmers' cooperative organization described in subsection (b) (1) shall be exempt from taxation under this subtitle except as otherwise provided in section 522. Notwithstanding section 522, such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

(b) APPLICABLE RULES.—

(1) EXEMPT FARMERS' COOPERATIVES.—The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are 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.

(2) ORGANIZATIONS HAVING CAPITAL STOCK.—Exemption shall not be denied any such association 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 association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

(3) ORGANIZATIONS MAINTAINING RESERVE.—Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(4) TRANSACTIONS WITH NONMEMBERS.—Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

(5) BUSINESS FOR THE UNITED STATES.—Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.

SEC. 522. TAX ON FARMERS' COOPERATIVES.

(a) IMPOSITION OF TAX.—An organization exempt from taxation under section 521 shall be subject to the taxes imposed by section 11 or section 1201.

(b) COMPUTATION OF TAXABLE INCOME.—

(1) GENERAL RULE.—In computing the taxable income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under this chapter)—

(A) amounts paid as dividends during the taxable year on its capital stock, and

(B) amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on

the last day of such taxable year to the extent the allocations are attributable to income derived before the close of such year.

(2) PATRONAGE DIVIDENDS, ETC.—Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund, or rebate) shall be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt under section 521. Such dividends, refunds, and rebates made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the dividends, refunds, or rebates, are attributable to patronage occurring before the close of such year.

PART IV—SHIPOWNERS' PROTECTION AND INDEMNITY ASSOCIATIONS

Sec. 526. Shipowners' protection and indemnity associations.

SEC. 526. SHIPOWNERS' PROTECTION AND INDEMNITY ASSOCIATIONS.

There shall not be included in gross income the receipts of shipowners' mutual protection and indemnity associations not organized for profit, and no part of the net earnings of which inures to the benefit of any private shareholder; but such corporations shall be subject as other persons to the tax on their taxable income from interest, dividends, and rents.

Subchapter G—Corporations Used to Avoid Income Tax on Shareholders

Part I. Corporations improperly accumulating surplus.
Part II. Personal holding companies.
Part III. Foreign personal holding companies.
Part IV. Deduction for dividends paid.

PART I—CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS

Sec. 531. Imposition of accumulated earnings tax.
Sec. 532. Corporations subject to accumulated earnings tax.
Sec. 533. Evidence of purpose to avoid income tax.
Sec. 534. Burden of proof.
Sec. 535. Accumulated taxable income.
Sec. 536. Income not placed on annual basis.
Sec. 537. Reasonable needs of the business.

SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) General Rule.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(b) Exceptions.—The accumulated earnings tax imposed by section 531 shall not apply to—

(1) a personal holding company (as defined in section 542).

(2) a foreign personal holding company (as defined in section 552), or

(3) a corporation exempt from tax under subchapter F (section 501 and following).

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) Unreasonable Accumulation Determinative of Purpose.—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) HOLDING OR INVESTMENT COMPANY.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

SEC. 534. BURDEN OF PROOF.

(a) GENERAL RULE.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) NOTIFICATION BY SECRETARY.—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531.

(c) STATEMENT BY TAXPAYER.—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

(d) JEOPARDY ASSESSMENT.—If pursuant to section 6861 (a) a jeopardy assessment is made before the mailing of the notice of deficiency referred to in subsection (a), for purposes of this section such notice of deficiency shall, to the extent that it informs the taxpayer that such deficiency includes the accumulated earnings tax imposed by section 531, constitute the notification described in subsection (b), and in that event the statement described in subsection (c) may be included in the taxpayer's petition to the Tax Court.

(e) EFFECTIVE DATE.—This section shall apply only with respect to a notice of deficiency for a taxable year to which this subchapter applies which is mailed more than 90 days after the date of enactment of this title.

SEC. 535. ACCUMULATED TAXABLE INCOME.

(a) DEFINITION.—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) ADJUSTMENTS TO TAXABLE INCOME.—For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) TAXES.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue

Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164 (b) (6)), accrued during the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions provided under section 170 shall be allowed without regard to the limitation in section 170 (b) (2).

(3) SPECIAL DEDUCTIONS DISALLOWED.—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) NET OPERATING LOSS.—The net operating loss deduction provided in section 172 shall not be allowed.

(5) CAPITAL LOSSES.—There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211 (a).

(6) LONG-TERM CAPITAL GAINS.—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including such excess in taxable income.

(7) CAPITAL LOSS CARRYOVER.—No allowance shall be made for the capital loss carryover provided in section 1212.

(8) BANK AFFILIATES.—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(c) ACCUMULATED EARNINGS CREDIT.—

(1) GENERAL RULE.—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) MINIMUM CREDIT.—The credit allowable under paragraph (1) shall in no case be less than the amount by which $60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) HOLDING AND INVESTMENT COMPANIES.—In the case of a corporation which is a mere holding or investment company, the

accumulated earnings credit is the amount (if any) by which $60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) ACCUMULATED EARNINGS AND PROFITS.—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563 (a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

(5) CROSS REFERENCE.—

For denial of credit provided in paragraph (2) or (3) where multiple corporations are formed to avoid tax, see section 1551.

SEC. 536. INCOME NOT PLACED ON ANNUAL BASIS.

Section 443 (b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the accumulated earnings tax imposed by section 531.

SEC. 537. REASONABLE NEEDS OF THE BUSINESS.

For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

PART II—PERSONAL HOLDING COMPANIES

Sec. 541. Imposition of personal holding company tax.
Sec. 542. Definition of personal holding company.
Sec. 543. Personal holding company income.
Sec. 544. Rules for determining stock ownership.
Sec. 545. Undistributed personal holding company income.
Sec. 546. Income not placed on annual basis.
Sec. 547. Deduction for deficiency dividends.

SEC. 541. IMPOSITION OF PERSONAL HOLDING COMPANY TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to the sum of—

(1) 75 percent of the undistributed personal holding company income not in excess of $2,000, plus

(2) 85 percent of the undistributed personal holding company income in excess of $2,000.

SEC. 542. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) GENERAL RULE.—For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

(1) GROSS INCOME REQUIREMENT.—At least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 543, and

(2) STOCK OWNERSHIP REQUIREMENT.—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 5 individuals. For purposes of this paragraph, an organization described in section 503 (b) or a portion of a trust

permanently set aside or to be used exclusively for the purposes described in section 642 (c) or a corresponding provision of a prior income tax law shall be considered an individual.

(b) CORPORATIONS FILING CONSOLIDATED RETURNS.—

(1) GENERAL RULE.—In the case of an affiliated group of corporations filing or required to file a consolidated return under section 1501 for any taxable year, the gross income requirement of subsection (a) (1) of this section shall, except as provided in paragraphs (2) and (3), be applied for such year with respect to the consolidated gross income and the consolidated personal holding company income of the affiliated group. No member of such an affiliated group shall be considered to meet such gross income requirement unless the affiliated group meets such requirement.

(2) INELIGIBLE AFFILIATED GROUP.—Paragraph (1) shall not apply to an affiliated group of corporations, other than an affiliated group of railroad corporations the common parent of which would be eligible to file a consolidated return under section 141 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942, if—

(A) any member of the affiliated group of corporations (including the common parent corporation) derived 10 percent or more of its gross income for the taxable year from sources outside the affiliated group, and

(B) 80 percent or more of the amount described in subparagraph (A) consists of personal holding company income (as defined in section 543).

For purposes of this paragraph, section 543 shall be applied as if the amount described in subparagraph (A) were the gross income of the corporation.

(3) EXCLUDED CORPORATIONS.—Paragraph (1) shall not apply to an affiliated group of corporations if any member of the affiliated group (including the common parent corporation) is a corporation excluded from the definition of personal holding company under subsection (c).

(4) CERTAIN DIVIDEND INCOME RECEIVED BY A COMMON PARENT.—In applying paragraph (2) (A) and (B), personal holding company income and gross income shall not include dividends received by a common parent corporation from another corporation if—

(A) the common parent corporation owns, directly or indirectly, more than 50 percent of the outstanding voting stock of such other corporation, and

(B) such other corporation is not a personal holding company for the taxable year in which the dividends are paid.

(c) EXCEPTIONS.—The term "personal holding company" as defined in subsection (a) does not include—

(1) a corporation exempt from tax under subchapter F (sec. 501 and following);

(2) a bank as defined in section 581;

(3) a life insurance company;

(4) a surety company;

(5) a foreign personal holding company as defined in section 552;

(6) a licensed personal finance company under State supervision, 80 percent or more of the gross income of which is lawful interest received from loans made to individuals in accordance with the provisions of applicable State law if at least 60 percent of such gross income is lawful interest—

(A) received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed in principal amount the limit prescribed for small loans by such law (or, if there is no such limit, $500), and

(B) not payable in advance or compounded and computed only on unpaid balances, and if the loans to a person, who is a shareholder in such company during the taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by the members of his family as defined in section 544 (a) (2)), outstanding at any time during such year do not exceed $5,000 in principal amount;

(7) a lending company, not otherwise excepted by this subsection, authorized to engage in the small loan business under one or more State statutes providing for the direct regulation of such business, 80 percent or more of the gross income of which is lawful interest, discount or other authorized charges—

(A) received from loans maturing in not more than 36 months made to individuals in accordance with the provisions of applicable State law, and

(B) which do not, in the case of any individual loan, exceed in the aggregate an amount equal to simple interest at the rate of 3 percent per month not payable in advance and computed only on unpaid balances, if at least 60 percent of the gross income is lawful interest, discount or other authorized charges received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed in principal amount the limit prescribed for small loans by such law (or, if there is no such limit, $500), and if the deductions allowed to such company under section 162 (relating to trade or business expenses), other than for compensation for personal services rendered by shareholders (including members of the shareholder's family as described in section 544 (a) (2)) constitute 15 percent or more of its gross income, and the loans to a person, who is a shareholder in such company during the taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by the members of his family as defined in section 544 (a) (2)), outstanding at any time during such year do not exceed $5,000 in principal amount;

(8) a loan or investment corporation, a substantial part of the business of which consists of receiving funds not subject to check and evidenced by installment or fully paid certificates of indebtedness or investment, and making loans and discounts, and the loans to a person who is a shareholder in such corporation during such taxable year by or for whom 10 percent or more in value

of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by the members of his family as defined in section 544 (a) (2)) outstanding at any time during such year do not exceed $5,000 in principal amount;

(9) a finance company, actively and regularly engaged in the business of purchasing or discounting accounts or notes receivable or installment obligations, or making loans secured by any of the foregoing or by tangible personal property, at least 80 percent of the gross income of which is derived from such business in accordance with the provisions of applicable State law or does not constitute personal holding company income as defined in section 543, if 60 percent of the gross income is derived from one or more of the following classes of transactions—

(A) purchasing or discounting accounts or notes receivable, or installment obligations evidenced or secured by contracts of conditional sale, chattel mortgages, or chattel lease agreements, arising out of the sale of goods or services in the course of the transferor's trade or business;

(B) making loans, maturing in not more than 36 months, to, and for the business purposes of, persons engaged in trade or business, secured by—

(i) accounts or notes receivable, or installment obligations, described in subparagraph (A);

(ii) warehouse receipts, bills of lading, trust receipts, chattel mortgages, bailments, or factor's liens, covering or evidencing the borrower's inventories;

(iii) a chattel mortgage on property used in the borrower's trade or business;

except loans to any single borrower which for more than 90 days in the taxable year of the company exceed 15 percent of the average funds employed by the company during such taxable year;

(C) making loans, in accordance with the provisions of applicable State law, secured by chattel mortgages on tangible personal property, the original amount of each of which is not less than the limit referred to in, or prescribed by, paragraph (6) (A), and the aggregate principal amount of which owing by any one borrower to the company at any time during the taxable year of the company does not exceed $5,000; and

(D) if 30 percent or more of the gross income of the company is derived from one or more of the classes of transactions described in subparagraphs (A), (B), and (C), purchasing, discounting, or lending upon the security of, installment obligations of individuals where the transferor or borrower acquired such obligations either in transactions of the classes described in subparagraphs (A) and (C) or as a result of loans made by such transferor or borrower in accordance with the provisions of subparagraphs (A) and (B) of paragraph (6) or of subparagraphs (A) and (B) of paragraph (7) of this subsection, if the funds so supplied at all times bear an agreed ratio to the unpaid balance of the assigned installment obligations, and documents evidencing such obligations are held by the company;

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provided that the deductions allowable under section 162 (relating to trade or business expenses), other than compensation for personal services rendered by shareholders (including members of the shareholder's family as described in section 544 (a) (2)), constitute 15 percent or more of the gross income, and that loans to a person who is a shareholder in such company during such taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by members of his family as defined in section 544 (a) (2)), outstanding at any time during such year do not exceed $5,000 in principal amount;

(10) a foreign corporation if—

(A) its gross income from sources within the United States for the period specified in section 861 (a) (2) (B) is less than 50 percent of its total gross income from all sources, and

(B) all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through other foreign corporations.

SEC. 543. PERSONAL HOLDING COMPANY INCOME.

(a) General Rule.—For purposes of this subtitle, the term "personal holding company income" means the portion of the gross income which consists of:

(1) Dividends, etc.—Dividends, interest, royalties (other than mineral, oil, or gas royalties), and annuities. This paragraph shall not apply to interest constituting rent as defined in paragraph (7) or to interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936.

(2) Stock and securities transactions.—Except in the case of regular dealers in stock or securities, gains from the sale or exchange of stock or securities.

(3) Commodities transactions.—Gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. This paragraph shall not apply to gains by a producer, processor, merchant, or handler of the commodity which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

(4) Estates and trusts.—Amounts includible in computing the taxable income of the corporation under part I of subchapter J (sec. 641 and following, relating to estates, trusts, and beneficiaries); and gains from the sale or other disposition of any interest in an estate or trust.

(5) Personal service contracts.—

(A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(B) amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(6) USE OF CORPORATION PROPERTY BY SHAREHOLDER.—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. This paragraph shall apply only to a corporation which has personal holding company income for the taxable year, computed without regard to this paragraph and paragraph (7), in excess of 10 percent of its gross income.

(7) RENTS.—Rents, unless constituting 50 percent or more of the gross income. For purposes of this paragraph, the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but does not include amounts constituting personal holding company income under paragraph (6).

(8) MINERAL, OIL, OR GAS ROYALTIES.—Mineral, oil, or gas royalties, unless—

(A) such royalties constitute 50 percent or more of the gross income, and

(B) the deductions allowable under section 162 (relating to trade or business expenses) other than compensation for personal services rendered by the shareholders, constitute 15 percent or more of the gross income.

(b) LIMITATION ON GROSS INCOME IN CERTAIN TRANSACTIONS.—For purposes of this part—

(1) gross income and personal holding company income determined with respect to transactions described in section 543 (a) (2) (relating to gains from stock and security transactions) shall include only the excess of gains over losses from such transactions, and

(2) gross income and personal holding company income determined with respect to transactions described in section 543 (a) (3) (relating to gains from commodity transactions) shall include only the excess of gains over losses from such transactions.

(c) GROSS INCOME OF INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.—In the case of an insurance company other than life or mutual, the term "gross income" as used in this part means the gross income, as defined in section 832 (b) (1), increased by the amount of losses incurred, as defined in section 832 (b) (5), and the amount of expenses incurred, as defined in section 832 (b) (6), and decreased by

the amount deductible under section 832 (c) (7) (relating to tax-free interest).

SEC. 544. RULES FOR DETERMINING STOCK OWNERSHIP.

(a) CONSTRUCTIVE OWNERSHIP.—For purposes of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership under section 542 (a) (2), section 543 (a) (5), or section 543 (a) (6)—

(1) STOCK NOT OWNED BY INDIVIDUAL.—Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

(2) FAMILY AND PARTNERSHIP OWNERSHIP.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For purposes of this paragraph, the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(3) OPTIONS.—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(4) APPLICATION OF FAMILY-PARTNERSHIP AND OPTION RULES.—Paragraphs (2) and (3) shall be applied—

(A) for purposes of the stock ownership requirement provided in section 542 (a) (2), if, but only if, the effect is to make the corporation a personal holding company;

(B) for purposes of section 543 (a) (5) (relating to personal service contracts), or of section 543 (a) (6) (relating to the use of property by shareholders), if, but only if, the effect is to make the amounts therein referred to includible under such paragraph as personal holding company income.

(5) CONSTRUCTIVE OWNERSHIP AS ACTUAL OWNERSHIP.—Stock constructively owned by a person by reason of the application of paragraph (1) or (3) shall, for purposes of applying paragraph (1) or (2), be treated as actually owned by such person; but stock constructively owned by an individual by reason of the application of paragraph (2) shall not be treated as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.

(6) OPTION RULE IN LIEU OF FAMILY AND PARTNERSHIP RULE.—If stock may be considered as owned by an individual under either paragraph (2) or (3) it shall be considered as owned by him under paragraph (3).

(b) CONVERTIBLE SECURITIES.—Outstanding securities convertible into stock (whether or not convertible during the taxable year) shall be considered as outstanding stock—

(1) for purposes of the stock ownership requirement provided in section 542 (a) (2), but only if the effect of the inclusion of all such securities is to make the corporation a personal holding company;

(2) for purposes of section 543 (a) (5) (relating to personal service contracts), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as personal holding company income; and

(3) for purposes of section 543 (a) (6) (relating to the use of property by shareholders), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as personal holding company income.

The requirement in paragraphs (1), (2), and (3) that all convertible securities must be included if any are to be included shall be subject to the exception that, where some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be included although the others are not included, but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also included.

SEC. 545. UNDISTRIBUTED PERSONAL HOLDING COMPANY INCOME.

(a) DEFINITION.—For purposes of this part, the term "undistributed personal holding company income" means the taxable income of a personal holding company adjusted in the manner provided in subsection (b), minus the dividends paid deduction as defined in section 561.

(b) ADJUSTMENTS TO TAXABLE INCOME.—For the purposes of subsection (a), the taxable income shall be adjusted as follows:

(1) TAXES.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164 (b) (6)), accrued during the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law. A taxpayer which, for each taxable year in which it was subject to the tax imposed by section 500 of the Internal Revenue Code of 1939, deducted Federal income and excess profits taxes when paid for the purpose of computing subchapter A net income under such Code, shall deduct taxes under this paragraph when paid, unless the taxpayer elects, in its return for a taxable year ending after June 30, 1954, to deduct the taxes described in this paragraph when accrued. Such an election shall be irrevocable and shall apply to the taxable year for which the election is made and to all subsequent taxable years.

(2) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions provided under section 170 shall be allowed but with the limitations in section 170 (b) (1) (A) and (B) (in lieu of the limitation in section 170 (b) (2)). For purposes of this paragraph, the term "adjusted gross income" when used in section 170 (b) (1) means the taxable income computed with the adjustments provided in section 170 (b) (2) and without the deduction of the amount disallowed under paragraph (8) of this subsection.

(3) SPECIAL DEDUCTIONS DISALLOWED.—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) NET OPERATING LOSS.—The net operating loss deduction provided in section 172 shall not be allowed, but there shall be allowed as a deduction the amount of the net operating loss (as defined in section 172 (c)) for the preceding taxable year.

(5) LONG-TERM CAPITAL GAINS.—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including such excess in taxable income.

(6) BANK AFFILIATES.—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(7) PAYMENT OF INDEBTEDNESS INCURRED PRIOR TO JANUARY 1, 1934.—There shall be allowed as a deduction amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.

(8) EXPENSES AND DEPRECIATION APPLICABLE TO PROPERTY OF THE TAXPAYER.—The aggregate of the deductions allowed under section 162 (relating to trade or business expenses) and section 167 (relating to depreciation), which are allocable to the operation and maintenance of property owned or operated by the corporation, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Secretary or his delegate) to the satisfaction of the Secretary or his delegate—

(A) that the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(B) that the property was held in the course of a business carried on bona fide for profit; and

(C) either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(9) AMOUNT OF A LIEN IN FAVOR OF THE UNITED STATES.—There shall be allowed as a deduction the amount, not to exceed the taxable income of the taxpayer, of any lien in favor of the United States (notice of which has been filed as provided in section 6323 (a) (1), (2), or (3)) to which the taxpayer is subject at the close of the taxable year. The sum of the amounts deducted under this paragraph with respect to any lien shall, for the purposes of this section, be added to the taxable income of the taxpayer for

the taxable year in which such lien is satisfied or released. Where an amount is added to the taxable income of a corporation by reason of the preceding sentence of this paragraph, the shareholders of the corporation may, pursuant to regulations prescribed by the Secretary or his delegate, elect to compute the income tax with respect to such dividends as are attributable to such amount as though they were received ratably over the period the lien was in effect.

SEC. 546. INCOME NOT PLACED ON ANNUAL BASIS.

Section 443 (b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the personal holding company tax imposed by section 541.

SEC. 547. DEDUCTION FOR DEFICIENCY DIVIDENDS.

(a) GENERAL RULE.—If a determination (as defined in subsection (c)) with respect to a taxpayer establishes liability for personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law) for any taxable year, a deduction shall be allowed to the taxpayer for the amount of deficiency dividends (as defined in subsection (d)) for the purpose of determining the personal holding company tax for such year, but not for the purpose of determining interest, additional amounts, or assessable penalties computed with respect to such personal holding company tax.

(b) RULES FOR APPLICATION OF SECTION.—

(1) ALLOWANCE OF DEDUCTION.—The deficiency dividend deduction shall be allowed as of the date the claim for the deficiency dividend deduction is filed.

(2) CREDIT OR REFUND.—If the allowance of a deficiency dividend deduction results in an overpayment of personal holding company tax for any taxable year, credit or refund with respect to such overpayment shall be made as if on the date of the determination 2 years remained before the expiration of the period of limitation on the filing of claim for refund for the taxable year to which the overpayment relates. No interest shall be allowed on a credit or refund arising from the application of this section.

(c) DETERMINATION.—For purposes of this section, the term "determination" means—

(1) a decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(2) a closing agreement made under section 7121; or

(3) under regulations prescribed by the Secretary or his delegate, an agreement signed by the Secretary or his delegate and by, or on behalf of, the taxpayer relating to the liability of such taxpayer for personal holding company tax.

(d) DEFICIENCY DIVIDENDS.—

(1) DEFINITION.—For purposes of this section, the term "deficiency dividends" means the amount of the dividends paid by the corporation on or after the date of the determination and before filing claim under subsection (e), which would have been includible in the computation of the deduction for dividends paid under sec-

tion 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. No dividends shall be considered as deficiency dividends for purposes of subsection (a) unless distributed within 90 days after the determination.

(2) EFFECT ON DIVIDENDS PAID DEDUCTION.—

(A) FOR TAXABLE YEAR IN WHICH PAID.—Deficiency dividends paid in any taxable year (to the extent of the portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be included in the amount of dividends paid for such year for purposes of computing the dividends paid deduction for such year and succeeding years.

(B) FOR PRIOR TAXABLE YEAR.—Deficiency dividends paid in any taxable year (to the extent of the portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be allowed for purposes of section 563 (b) in the computation of the dividends paid deduction for the taxable year preceding the taxable year in which paid.

(e) CLAIM REQUIRED.—No deficiency dividend deduction shall be allowed under subsection (a) unless (under regulations prescribed by the Secretary or his delegate) claim therefor is filed within 120 days after the determination.

(f) SUSPENSION OF STATUTE OF LIMITATIONS AND STAY OF COLLECTION.—

(1) SUSPENSION OF RUNNING OF STATUTE.—If the corporation files a claim, as provided in subsection (e), the running of the statute of limitations provided in section 6501 on the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of the deficiency and all interest, additional amounts, or assessable penalties, shall be suspended for a period of 2 years after the date of the determination.

(2) STAY OF COLLECTION.—In the case of any deficiency with respect to the tax imposed by section 541 established by a determination under this section—

(A) the collection of the deficiency and all interest, additional amounts, and assessable penalties shall, except in cases of jeopardy, be stayed until the expiration of 120 days after the date of the determination, and

(B) if claim for deficiency dividend deduction is filed under subsection (e), the collection of such part of the deficiency as is not reduced by the deduction for deficiency dividends provided in subsection (a) shall be stayed until the date the claim is disallowed (in whole or in part), and if disallowed in part collection shall be made only with respect to the part disallowed.

No distraint or proceeding in court shall be begun for the collection of an amount the collection of which is stayed under subparagraph (A) or (B) during the period for which the collection of such amount is stayed.

(g) DEDUCTION DENIED IN CASE OF FRAUD, ETC.—No deficiency dividend deduction shall be allowed under subsection (a) if the determination contains a finding that any part of the deficiency is due to

fraud with intent to evade tax, or to wilful failure to file an income tax return within the time prescribed by law or prescribed by the Secretary or his delegate in pursuance of law.

(h) EFFECTIVE DATE.—Subsections (a) through (f), inclusive, shall apply only with respect to determinations made more than 90 days after the date of enactment of this title. If the taxable year with respect to which the deficiency is asserted began before January 1, 1954, the term "deficiency dividend" includes only amounts which would have been includible in the computation under the Internal Revenue Code of 1939 of the basic surtax credit for such taxable year. Subsection (g) shall apply only if the taxable year with respect to which the deficiency is asserted begins after December 31, 1953.

PART III—FOREIGN PERSONAL HOLDING COMPANIES

Sec. 551. Foreign personal holding company income taxed to United States shareholders.
Sec. 552. Definition of foreign personal holding company.
Sec. 553. Foreign personal holding company income.
Sec. 554. Stock ownership.
Sec. 555. Gross income of foreign personal holding companies.
Sec. 556. Undistributed foreign personal holding company income.
Sec. 557. Income not placed on annual basis.

SEC. 551. FOREIGN PERSONAL HOLDING COMPANY INCOME TAXED TO UNITED STATES SHAREHOLDERS.

(a) GENERAL RULE.—The undistributed foreign personal holding company income of a foreign personal holding company shall be included in the gross income of the citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts (other than estates or trusts the gross income of which under this subtitle includes only income from sources within the United States), who are shareholders in such foreign personal holding company (hereinafter called "United States shareholders") in the manner and to the extent set forth in this part.

(b) AMOUNT INCLUDED IN GROSS INCOME.—Each United States shareholder, who was a shareholder on the day in the taxable year of the company which was the last day on which a United States group (as defined in section 552 (a) (2)) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend if on such last day there had been distributed by the company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

(c) DEDUCTION FOR OBLIGATIONS OF UNITED STATES AND ITS INSTRUMENTALITIES.—Each United States shareholder shall take into account in determining his income tax his proportionate share of partially tax-exempt interest on obligations described in section 35 or 242 which is included in the gross income of the company otherwise than by the application of the provisions of section 555 (b) (relating to the inclusion in the gross income of a foreign personal holding

company of its distributive share of the undistributed foreign personal holding company income of another foreign personal holding company in which it is a shareholder). If the foreign personal holding company elects under section 171 to amortize the premiums on such obligations, for purposes of the preceding sentence each United States shareholder's proportionate share of such interest received by the foreign personal holding company shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 171 as is attributable to such share.

(d) INFORMATION IN RETURN.—Every United States shareholder who is required under subsection (b) to include in his gross income any amount with respect to the undistributed foreign personal holding company income of a foreign personal holding company and who, on the last day on which a United States group existed with respect to the company, owned 5 percent or more in value of the outstanding stock of such company, shall set forth in his return in complete detail the gross income, deductions and credits, taxable income, foreign personal holding company, and undistributed foreign personal holding company income of such company.

(e) EFFECT ON CAPITAL ACCOUNT OF FOREIGN PERSONAL HOLDING COMPANY.—An amount which bears the same ratio to the undistributed foreign personal holding company income of the foreign personal holding company for its taxable year as the portion of such taxable year up to and including the last day on which a United States group existed with respect to the company bears to the entire taxable year, shall, for the purpose of determining the effect of distributions in subsequent taxable years by the corporation, be considered as paid-in surplus or as a contribution to capital, and the accumulated earnings and profits as of the close of the taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend, directly or indirectly, in the gross income of United States shareholders.

(f) BASIS OF STOCK IN HANDS OF SHAREHOLDERS.—The amount required to be included in the gross income of a United States shareholder under subsection (b) shall, for the purpose of adjusting the basis of his stock with respect to which the distribution would have been made (if it had been made), be treated as having been reinvested by the shareholder as a contribution to the capital of the corporation; but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in the last determination of the shareholder's tax liability, made before the expiration of 6 years after the date prescribed by law for filing the return.

(g) CROSS REFERENCES.—

(1) For basis of stock or securities in a foreign personal holding company acquired from a decedent, see section 1014 (b) (5).

(2) For period of limitation on assessment and collection without assessment, in case of failure to include in gross income the amount properly includible therein under subsection (b), see section 6501.

(3) For treatment of gain on liquidation of certain foreign personal holding companies, see section 342.

SEC. 552. DEFINITION OF FOREIGN PERSONAL HOLDING COMPANY.

(a) GENERAL RULE.—For purposes of this subtitle, the term "foreign personal holding company" means any foreign corporation if—

(1) GROSS INCOME REQUIREMENT.—At least 60 percent of its gross income (as defined in section 555 (a)) for the taxable year is foreign personal holding company income as defined in section 553; but if the corporation is a foreign personal holding company with respect to any taxable year ending after August 26, 1937, then, for each subsequent taxable year, the minimum percentage shall be 50 percent in lieu of 60 percent, until a taxable year during the whole of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 50 percent of the gross income is foreign personal holding company income. For purposes of this paragraph, there shall be included in the gross income the amount includible therein as a dividend by reason of the application of section 555 (c) (2); and

(2) STOCK OWNERSHIP REQUIREMENT.—At any time during 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 who are citizens or residents of the United States, hereinafter called "United States group".

(b) EXCEPTIONS.—The term "foreign personal holding company" does not include—

(1) a corporation exempt from tax under subchapter F (sec. 501 and following); and

(2) a corporation organized and doing business under the banking and credit laws of a foreign country if it is established (annually or at other periodic intervals) to the satisfaction of the Secretary or his delegate that such corporation is not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed upon its shareholders. If the Secretary or his delegate is satisfied that such corporation is not so formed or availed of, he shall issue to such corporation annually or at other periodic intervals a certification that the corporation is not a foreign personal holding company.

Each United States shareholder of a foreign corporation which would, except for the provisions of paragraph (2), be a foreign personal holding company, shall attach to and file with his income tax return for the taxable year a copy of the certification by the Secretary or his delegate made pursuant to paragraph (2). Such copy shall be filed with the taxpayer's return for the taxable year if he has been a shareholder of such corporation for any part of such year.

SEC. 553. FOREIGN PERSONAL HOLDING COMPANY INCOME.

For purposes of this subtitle, the term "foreign personal holding company income" means the portion of the gross income, determined for purposes of section 552, which consists of personal holding company income, as defined in section 543, except that all interest, whether or not treated as rent, and all royalties, whether or not mineral, oil, or gas royalties, shall constitute "foreign personal holding company income".

SEC. 554. STOCK OWNERSHIP.

For purposes of determining whether a foreign corporation is a foreign personal holding company, insofar as such determination is based on stock ownership, the rules provided in section 544 shall be applicable as if any reference in such section to a personal holding company was a reference to a foreign personal holding company and as if any reference in such section to a provision of part II (relating to personal holding companies) was a reference to the corresponding provision of this part.

SEC. 555. GROSS INCOME OF FOREIGN PERSONAL HOLDING COMPANIES.

(a) GENERAL RULE.—For purposes of this part, the term "gross income" means, with respect to a foreign corporation, gross income computed (without regard to the provisions of subchapter N (sec. 861 and following)) as if the foreign corporation were a domestic corporation which is a personal holding company.

(b) ADDITIONS TO GROSS INCOME.—In the case of a foreign personal holding company (whether or not a United States group, as defined in section 552 (a) (2), existed with respect to such company on the last day of its taxable year) which was a shareholder in another foreign personal holding company on the day in the taxable year of the second company which was the last day on which a United States group existed with respect to the second company, there shall be included, as a dividend, in the gross income of the first company, for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend if on such last day there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.

(c) APPLICATION OF SUBSECTION (b).—The rule provided in subsection (b)—

(1) shall be applied in the case of a foreign personal holding company for the purpose of determining its undistributed foreign personal holding company income which, or a part of which, is to be included in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies;

(2) shall be applied in the case of every foreign corporation with respect to which a United States group exists on some day of its taxable year, for the purpose of determining whether such corporation meets the gross income requirements of section 552 (a) (1).

SEC. 556. UNDISTRIBUTED FOREIGN PERSONAL HOLDING COMPANY INCOME.

(a) DEFINITION.—For purposes of this part, the term "undistributed foreign personal holding company income" means the taxable income of a foreign personal holding company adjusted in the manner provided in subsection (b), minus the dividends paid deduction (as defined in section 561).

(b) ADJUSTMENTS TO TAXABLE INCOME.—For the purposes of subsection (a), the taxable income shall be adjusted as follows:

(1) TAXES.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess-profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164 (b) (6)), accrued during the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law. A taxpayer which, for each taxable year in which it was subject to the provisions of supplement P of the Internal Revenue Code of 1939, deducted Federal income and excess profits taxes when paid for the purpose of computing undistributed supplement P net income under such code, shall deduct taxes under this paragraph when paid, unless the corporation elects, under regulations prescribed by the Secretary or his delegate, after the date of enactment of this title to deduct the taxes described in this paragraph when accrued. Such election shall be irrevocable and shall apply to the taxable year for which the election is made and to all subsequent taxable years.

(2) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions provided under section 170 shall be allowed, but with the limitation in section 170 (b) (1) (A) and (B) (in lieu of the limitation in section 170 (b) (2)). For purposes of this paragraph, the term "adjusted gross income" when used in section 170 (b) (1) means the taxable income computed with the adjustments provided in section 170 (b) (2) and without the deduction of the amounts disallowed under paragraphs (5) and (6) of this subsection or the inclusion in gross income of the amounts includible therein as dividends by reason of the application of the provisions of section 555 (b) (relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder).

(3) SPECIAL DEDUCTIONS DISALLOWED.—The special deductions for corporations provided in part VIII (except sections 242 and 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) NET OPERATING LOSS.—The net operating loss deduction provided in section 172 shall not be allowed, but there shall be allowed as a deduction the amount of the net operating loss (as defined in section 172 (c)) for the preceding taxable year.

(5) EXPENSES AND DEPRECIATION APPLICABLE TO PROPERTY OF THE TAXPAYER.—The aggregate of the deductions allowed under section 162 (relating to trade or business expenses) and section 167 (relating to depreciation) which are allocable to the operation and maintenance of property owned or operated by the company, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Secretary or his delegate) to the satisfaction of the Secretary or his delegate—

(A) that the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(B) that the property was held in the course of a business carried on bona fide for profit; and

(C) either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(6) TAXES AND CONTRIBUTIONS TO PENSION TRUSTS.—The deductions provided in section 164 (e) (relating to taxes of a shareholder paid by the corporation) and in section 404 (relating to pension, etc., trusts) shall not be allowed.

SEC. 557. INCOME NOT PLACED ON ANNUAL BASIS.

Section 443 (b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the undistributed foreign personal holding company income under section 556.

PART IV—DEDUCTION FOR DIVIDENDS PAID

Sec. 561. Definition of deduction for dividends paid.
Sec. 562. Rules applicable in determining dividends eligible for dividends paid deduction.
Sec. 563. Rules relating to dividends paid after close of taxable year.
Sec. 564. Dividend carryover.
Sec. 565. Consent dividends.

SEC. 561. DEFINITION OF DEDUCTION FOR DIVIDENDS PAID.

(a) GENERAL RULE.—The deduction for dividends paid shall be the sum of—

(1) the dividends paid during the taxable year,

(2) the consent dividends for the taxable year (determined under section 565), and

(3) in the case of a personal holding company, the dividend carryover described in section 564.

(b) SPECIAL RULES APPLICABLE.—In determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable in determining dividends eligible for dividends paid deduction) and section 563 (relating to dividends paid after the close of the taxable year) shall be applicable.

SEC. 562. RULES APPLICABLE IN DETERMINING DIVIDENDS ELIGIBLE FOR DIVIDENDS PAID DEDUCTION.

(a) GENERAL RULE.—For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

(b) DISTRIBUTIONS IN LIQUIDATION.—In the case of amounts distributed in liquidation, the part of such distribution which is properly chargeable to earnings and profits accumulated after February 28, 1913, shall be treated as a dividend for purposes of computing the dividends paid deduction. In the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period pursuant to such plan shall, to

the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which such distribution is made, be treated as a dividend for purposes of computing the dividends paid deduction.

(c) PREFERENTIAL DIVIDENDS.—The amount of any distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference.

(d) DISTRIBUTIONS BY A MEMBER OF AN AFFILIATED GROUP.—In the case where a corporation which is a member of an affiliated group of corporations filing or required to file a consolidated return for a taxable year is required to file a separate personal holding company schedule for such taxable year, a distribution by such corporation to another member of the affiliated group shall be considered as a dividend for purposes of computing the dividends paid deduction if such distribution would constitute a dividend under the other provisions of this section to a recipient which is not a member of an affiliated group.

SEC. 563. RULES RELATING TO DIVIDENDS PAID AFTER CLOSE OF TAXABLE YEAR.

(a) ACCUMULATED EARNINGS TAX.—In the determination of the dividends paid deduction for purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall be considered as paid during such taxable year.

(b) PERSONAL HOLDING COMPANY TAX.—In the determination of the dividends paid deduction for purposes of the personal holding company tax imposed by section 541, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall, to the extent the taxpayer elects in its return for the taxable year, be considered as paid during such taxable year. The amount allowed as a dividend by reason of the application of this subsection with respect to any taxable year shall not exceed either—

(1) The undistributed personal holding company income of the corporation for the taxable year, computed without regard to this subsection, or

(2) 10 percent of the sum of the dividends paid during the taxable year, computed without regard to this subsection.

(c) DIVIDENDS CONSIDERED AS PAID ON LAST DAY OF TAXABLE YEAR.—For the purpose of applying section 562 (a), with respect to distributions under subsection (a) or (b) of this section, a distribution made after the close of a taxable year and on or before the 15th day of the third month following the close of the taxable year shall be considered as made on the last day of such taxable year.

SEC. 564. DIVIDEND CARRYOVER.

(a) General Rule.—For purposes of computing the dividends paid deduction under section 561, in the case of a personal holding company the dividend carryover for any taxable year shall be the dividend carryover to such taxable year, computed as provided in subsection (b), from the two preceding taxable years.

(b) Computation of Dividend Carryover.—The dividend carryover to the taxable year shall be determined as follows:

(1) For each of the 2 preceding taxable years there shall be determined the taxable income computed with the adjustments provided in section 545 (whether or not the taxpayer was a personal holding company for either of such preceding taxable years), and there shall also be determined for each such year the deduction for dividends paid during such year as provided in section 561 (but determined without regard to the dividend carryover to such year).

(2) There shall be determined for each such taxable year whether there is an excess of such taxable income over such deduction for dividends paid or an excess of such deduction for dividends paid over such taxable income, and the amount of each such excess.

(3) If there is an excess of such deductions for dividends paid over such taxable income for the first preceding taxable year, such excess shall be allowed as a dividend carryover to the taxable year.

(4) If there is an excess of such deduction for dividends paid over such taxable income for the second preceding taxable year, such excess shall be reduced by the amount determined in paragraph (5), and the remainder of such excess shall be allowed as a dividend carryover to the taxable year.

(5) The amount of the reduction specified in paragraph (4) shall be the amount of the excess of the taxable income, if any, for the first preceding taxable year over such deduction for dividends paid, if any, for the first preceding taxable year.

(c) Determination of Dividend Carryover From Taxable Years to Which This Subtitle Does Not Apply.—In a case where the first or second preceding taxable year began before the taxpayer's first taxable year under this subtitle, the amount of the dividend carryover to taxable years to which this subtitle applies shall be determined under the provisions of the Internal Revenue Code of 1939.

SEC. 565. CONSENT DIVIDENDS.

(a) General Rule.—If any person owns consent stock (as defined in subsection (f) (1)) in a corporation on the last day of the taxable year of such corporation, and such person agrees, in a consent filed with the return of such corporation in accordance with regulations prescribed by the Secretary or his delegate, to treat as a dividend the amount specified in such consent, the amount so specified shall, except as provided in subsection (b), constitute a consent dividend for purposes of section 561 (relating to the deduction for dividends paid).

(b) Limitations.—A consent dividend shall not include—

(1) an amount specified in a consent which, if distributed in money, would constitute, or be part of, a distribution which would be disqualified for purposes of the dividends paid deduction under section 562 (c) (relating to preferential dividends), or

(2) an amount specified in a consent which would not constitute a dividend (as defined in section 316) if the total amounts specified in consents filed by the corporation had been distributed in money to shareholders on the last day of the taxable year of such corporation.

(c) EFFECT OF CONSENT.—The amount of a consent dividend shall be considered, for purposes of this title—

(1) as distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, and

(2) as contributed to the capital of the corporation by the shareholder on such day.

(d) CONSENT DIVIDENDS AND OTHER DISTRIBUTIONS.—If a distribution by a corporation consists in part of consent dividends and in part of money or other property, the entire amount specified in the consents and the amount of such money or other property shall be considered together for purposes of applying this title.

(e) NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.—In the case of a consent dividend which, if paid in money would be subject to the provisions of section 1441 (relating to withholding of tax on nonresident aliens) or section 1442 (relating to withholding of tax on foreign corporations), this section shall not apply unless the consent is accompanied by money, or such other medium of payment as the Secretary or his delegate may by regulations authorize, in an amount equal to the amount that would be required to be deducted and withheld under sections 1441 or 1442 if the consent dividend had been, on the last day of the taxable year of the corporation, paid to the shareholder in money as a dividend. The amount accompanying the consent shall be credited against the tax imposed by this subtitle on the shareholder.

(f) DEFINITIONS.—

(1) CONSENT STOCK.—Consent stock, for purposes of this section, means the class or classes of stock entitled, after the payment of preferred dividends, to a share in the distribution (other than in complete or partial liquidation) within the taxable year of all the remaining earnings and profits, which share constitutes the same proportion of such distribution regardless of the amount of such distribution.

(2) PREFERRED DIVIDENDS.—Preferred dividends, for purposes of this section, means a distribution (other than in complete or partial liquidation), limited in amount, which must be made on any class of stock before a further distribution (other than in complete or partial liquidation) of earnings and profits may be made within the taxable year.

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Subchapter H—Banking Institutions

Part I. Rules of general application to banking institutions.
Part II. Mutual savings banks, etc.
Part III. Bank affiliates.

PART I—RULES OF GENERAL APPLICATION TO BANKING INSTITUTIONS

Sec. 581. Definition of bank.
Sec. 582. Bad debt and loss deduction with respect to securities held by banks.
Sec. 583. Deductions of dividends paid on certain preferred stock.
Sec. 584. Common trust funds.

SEC. 581. DEFINITION OF BANK.

For purposes of sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act (38 Stat. 262; 12 U. S. C. 248 (k)), and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

SEC. 582. BAD DEBT AND LOSS DEDUCTION WITH RESPECT TO SECURITIES HELD BY BANKS.

(a) SECURITIES.—Notwithstanding sections 165 (g) (1) and 166 (e), subsections (a), (b), and (c) of section 166 (relating to allowance of deduction for bad debts) shall apply in the case of a bank to a debt which is evidenced by a security as defined in section 165 (g) (2) (C).

(b) WORTHLESS STOCK IN AFFILIATED BANK.—For purposes of section 165 (g) (1), where the taxpayer is a bank and owns directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset.

(c) BOND, ETC., LOSSES OF BANKS.—For purposes of this subtitle, in the case of a bank, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

SEC. 583. DEDUCTIONS OF DIVIDENDS PAID ON CERTAIN PREFERRED STOCK.

In computing the taxable income of any national banking association, or of any bank or trust company organized under the laws of

any State, Territory, possession of the United States, or the Canal Zone, or of any other banking corporation engaged in the business of industrial banking and under the supervision of a State banking department or of the Comptroller of the Currency, or of any incorporated domestic insurance company, there shall be allowed as a deduction from gross income, in addition to deductions otherwise provided for in this subtitle, any dividend (not including any distribution in liquidation) paid, within the taxable year, to the United States or to any instrumentality thereof exempt from Federal income taxes, on the preferred stock of the corporation owned by the United States or such instrumentality. The amount allowable as a deduction under this section shall reduce the deduction for dividends paid otherwise computed under section 561.

SEC. 584. COMMON TRUST FUNDS.

(a) DEFINITIONS.—For purposes of this subtitle, the term "common trust fund" means a fund maintained by a bank—

(1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and

(2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks.

(b) TAXATION OF COMMON TRUST FUNDS.—A common trust fund shall not be subject to taxation under this chapter and for purposes of this chapter shall not be considered a corporation.

(c) INCOME OF PARTICIPANTS IN FUND.—

(1) INCLUSIONS IN TAXABLE INCOME.—Each participant in the common trust fund in computing its taxable income shall include, whether or not distributed and whether or not distributable—

(A) as part of its gains and losses from sales or exchanges of capital assets held for not more than 6 months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for not more than 6 months;

(B) as part of its gains and losses from sales or exchanges of capital assets held for more than 6 months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for more than 6 months;

(C) its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in subsection (d).

(2) DIVIDENDS AND PARTIALLY TAX EXEMPT INTEREST.—The proportionate share of each participant in the amount of dividends to which section 34 or section 116 applies, and in the amount of partially tax exempt interest on obligations described in section 35 or section 242, received by the common trust fund shall be considered for purposes of such sections as having been received by such participant. If the common trust fund elects under section 171 (relating to amortizable bond premium) to amortize the premium on such obligations, for purposes of the preceding sentence the proportionate share of the participant of such interest received

by the common trust fund shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 171 as is attributable to such share.

(d) COMPUTATION OF COMMON TRUST FUND INCOME.—The taxable income of a common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(1) there shall be segregated the gains and losses from sales or exchanges of capital assets;

(2) after excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed—

(A) an ordinary taxable income which shall consist of the excess of the gross income over deductions; or

(B) an ordinary net loss which shall consist of the excess of the deductions over the gross income;

(3) the deduction provided by section 170 (relating to charitable, etc., contributions and gifts) shall not be allowed; and

(4) the standard deduction provided in section 141 shall not be allowed.

(e) ADMISSION AND WITHDRAWAL.—No gain or loss shall be realized by the common trust fund by the admission or withdrawal of a participant. The withdrawal of any participating interest by a participant shall be treated as a sale or exchange of such interest by the participant.

(f) DIFFERENT TAXABLE YEARS OF COMMON TRUST FUND AND PARTICIPANT.—If the taxable year of the common trust fund is different from that of a participant, the inclusions with respect to the taxable income of the common trust fund, in computing the taxable income of the participant for its taxable year, shall be based upon the taxable income of the common trust fund for any taxable year of the common trust fund ending within or with the taxable year of the participant.

(g) NET OPERATING LOSS DEDUCTION.—The benefit of the deduction for net operating losses provided by section 172 shall not be allowed to a common trust fund, but shall be allowed to the participants in the common trust fund under regulations prescribed by the Secretary or his delegate.

PART II—MUTUAL SAVINGS BANKS, ETC.

Sec. 591. Deduction for dividends paid on deposits.
Sec. 592. Deduction for repayment of certain loans.
Sec. 593. Additions to reserve for bad debts.
Sec. 594. Alternative tax for mutual savings banks conducting life insurance business.

SEC. 591. DEDUCTION FOR DIVIDENDS PAID ON DEPOSITS.

In the case of mutual savings banks, cooperative banks, and domestic building and loan associations, there shall be allowed as deductions in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

SEC. 592. DEDUCTION FOR REPAYMENT OF CERTAIN LOANS.

In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, there shall be allowed as deductions in computing taxable income amounts paid by the taxpayer during the taxable year in repayment of loans made before September 1, 1951, by (1) the United States or any agency or instrumentality thereof which is wholly owned by the United States, or (2) any mutual fund established under the authority of the laws of any State.

SEC. 593. ADDITIONS TO RESERVE FOR BAD DEBTS.

In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, the reasonable addition to a reserve for bad debts under section 166 (c) shall be determined with due regard to the amount of the taxpayer's surplus or bad debt reserves existing at the close of December 31, 1951. In the case of a taxpayer described in the preceding sentence, the reasonable addition to a reserve for bad debts for any taxable year shall in no case be less than the amount determined by the taxpayer as the reasonable addition for such year; except that the amount determined by the taxpayer under this sentence shall not be greater than the lesser of—

(1) the amount of its taxable income for the taxable year, computed without regard to this section, or

(2) the amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

SEC. 594. ALTERNATIVE TAX FOR MUTUAL SAVINGS BANKS CONDUCTING LIFE INSURANCE BUSINESS.

(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 taxable income (as defined in section 803) 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.

(b) LIMITATIONS OF SECTION.—Subsection (a) shall apply only if the life insurance department would, if it were treated as a separate corporation, qualify as a life insurance company under section 801.

PART III—BANK AFFILIATES

Sec. 601. Special deduction for bank affiliates.

SEC. 601. SPECIAL DEDUCTION FOR BANK AFFILIATES.

In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933; 12 U. S. C. 221a (c)), there shall be allowed as a deduction, for purposes of section 535 (b) (8) (relating to the computation of accumulated taxable income) and section 545 (b) (6) (relating to the computation of undistributed personal holding company income), the amount of the earnings and profits which the Board of Governors of the Federal Reserve System certifies to the Secretary or to his delegate has been devoted by such affiliate during the taxable year to the acquisition of readily marketable assets other than bank stock in compliance with section 5144 of the Revised Statutes (12 U. S. C. 61). The amount of the deduction under this section for any taxable year shall not exceed the taxable income for such year computed without regard to the special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.). The aggregate of the deductions allowable under this section and the credits allowable under the corresponding provision of any prior income tax law for all taxable years shall not exceed the amount required to be devoted under such section 5144 to such purposes.

Subchapter I—Natural Resources

Part I. Deductions.
Part II. Exclusions from gross income.
Part III. Sales and exchanges.

PART I—DEDUCTIONS

Sec. 611. Allowance of deduction for depletion.
Sec. 612. Basis for cost depletion.
Sec. 613. Percentage depletion.
Sec. 614. Definition of property.
Sec. 615. Exploration expenditures.
Sec. 616. Development expenditures.

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) GENERAL RULE.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613 (c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

(b) SPECIAL RULES.—

(1) LEASES.—In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

(2) LIFE TENANT AND REMAINDERMAN.—In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

(3) PROPERTY HELD IN TRUST.—In the case of property held in trust, the deduction under this section shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

(4) PROPERTY HELD BY ESTATE.—In the case of an estate, the deduction under this section shall be apportioned between the estate and the heirs, legatees, and devises on the basis of the income of the estate allocable to each.

(c) CROSS REFERENCE.—

For other rules applicable to depreciation of improvements, see section 167.

SEC. 612. BASIS FOR COST DEPLETION.

Except as otherwise provided in this subchapter, the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain upon the sale or other disposition of such property.

SEC. 613. PERCENTAGE DEPLETION.

(a) GENERAL RULE.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) PERCENTAGE DEPLETION RATES.—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

(2) 23 percent—

(A) sulfur and uranium; and

(B) if from deposits in the United States—anorthosite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, beryl, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc.

(3) 15 percent—ball clay, bentonite, china clay, sagger clay, metal mines (if paragraph (2) (B) does not apply), rock asphalt, and vermiculite.

(4) 10 percent—asbestos (if paragraph (2) (B) does not apply), brucite, coal, lignite, perlite, sodium chloride, and wollastonite.

(5) 5 percent—

(A) brick and tile clay, gravel, mollusk shells (including clam shells and oyster shells), peat, pumice, sand, scoria, shale, and stone, except stone described in paragraph (6); and

(B) if from brine wells—bromine, calcium chloride, and magnesium chloride.

(6) 15 percent—all other minerals (including, but not limited to, aplite, barite, borax, calcium carbonates, refractory and fire clay, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (2) (B) does not apply) bauxite, beryl, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc, including pyrophyllite), except that, unless sold on bid in direct competition with a bona

fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water, or mosses; or

(B) minerals from sea water, the air, or similar inexhaustible sources.

(c) DEFINITION OF GROSS INCOME FROM PROPERTY.—For purposes of this section—

(1) GROSS INCOME FROM THE PROPERTY.—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) MINING.—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

(3) EXTRACTION OF THE ORES OR MINERALS FROM THE GROUND.—The term "extraction of the ores or minerals from the ground" includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The preceding sentence shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom.

(4) ORDINARY TREATMENT PROCESSES.—The term "ordinary treatment processes" includes the following:

(A) In the case of coal—cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(B) in the case of sulfur recovered by the Frasch process—pumping to vats, cooling, breaking, and loading for shipment;

(C) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment;

(D) in the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash, and ores which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including as an ordinary treatment process electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores; and

(E) the pulverization of talc, the burning of magnesite, and the sintering and nodulizing of phosphate rock.

SEC. 614. DEFINITION OF PROPERTY.

(a) GENERAL RULE.—For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

(b) SPECIAL RULE AS TO OPERATING MINERAL INTERESTS.—

(1) ELECTION TO AGGREGATE SEPARATE INTERESTS.—If a taxpayer owns two or more separate operating mineral interests which constitute part or all of an operating unit, he may elect (for all purposes of this subtitle)—

(A) to form one aggregation of, and to treat as one property, any two or more of such interests; and

(B) to treat as a separate property each such interest which he does not elect to include within the aggregation referred to in subparagraph (A).

For purposes of the preceding sentence, separate operating mineral interests which constitute part or all of an operating unit may be aggregated whether or not they are included in a single tract or parcel of land and whether or not they are included in contiguous tracts or parcels. A taxpayer may not elect to form more than one aggregation of operating mineral interests within any one operating unit.

(2) MANNER AND SCOPE OF ELECTION.—The election provided by paragraph (1) shall be made, for each operating mineral interest in accordance with regulations prescribed by the Secretary or his delegate, not later than the time prescribed by law for filing the return (including extensions thereof) for whichever of the following taxable years is the later: The first taxable year beginning after December 31, 1953, or the first taxable year in which any expenditure for exploration, development, or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest. Such an election shall be binding upon the taxpayer for all subsequent taxable years, except that the Secretary or his delegate may consent to a different treatment of the interest with respect to which the election has been made.

(3) OPERATING MINERAL INTERESTS DEFINED.—For purposes of this subsection, the term "operating mineral interest" includes only an interest in respect of which the costs of production of the mineral are required to be taken into account by the taxpayer for purposes of computing the 50 percent limitation provided for in section 613, or would be so required if the mine, well, or other natural deposit were in the production stage.

(c) SPECIAL RULE AS TO NONOPERATING MINERAL INTERESTS.—

(1) AGGREGATION OF SEPARATE INTERESTS.—If a taxpayer owns two or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more contiguous tracts or parcels of land, the Secretary or his delegate may, on showing of undue hardship, permit the taxpayer to treat (for all purposes of this subtitle) all such mineral interests as one property. If such

permission is granted for any taxable year, the taxpayer shall treat such interests as one property for all subsequent taxable years unless the Secretary or his delegate consents to a different treatment.

(2) NONOPERATING MINERAL INTERESTS DEFINED.—For purposes of this subsection, the term "nonoperating mineral interests" includes only interests which are not operating mineral interests within the meaning of subsection (b) (3).

SEC. 615. EXPLORATION EXPENDITURES.

(a) IN GENERAL.—In the case of expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred before the beginning of the development stage of the mine or deposit, there shall be allowed as a deduction in computing taxable income so much of such expenditures as does not exceed $100,000. This section shall apply only with respect to the amount of such expenditures which, but for this section, would not be allowable as a deduction for the taxable year. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures paid or incurred. In no case shall this section apply with respect to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas.

(b) ELECTION OF TAXPAYER.—If the taxpayer elects, in accordance with regulations prescribed by the Secretary or his delegate, to treat as deferred expenses any portion of the amount deductible for the taxable year under subsection (a), such portion shall not be deductible in the manner provided in subsection (a) but shall be deductible on a ratable basis as the units of produced ores or minerals discovered or explored by reason of such expenditures are sold. An election made under this subsection for any taxable year shall be binding for such year.

(c) LIMITATION.—This section shall not apply to any amount paid or incurred in any taxable year if in any 4 preceding years a deduction or election under this section, or the corresponding provision of prior laws, has been allowed to, or exercised by—

(1) the taxpayer, or

(2) the individual or corporation who has transferred to the taxpayer any mineral property.

Paragraph (2) shall apply only if (A) the taxpayer was required to take into account under section 23 (ff) (3) of the Internal Revenue Code of 1939 the deduction allowed to or election exercised by such individual or corporation; (B) the taxpayer would be entitled under section 381 (c) (10) to deduct expenses deferred under this section had the distributor or transferor corporation elected to defer such expenses; or (C) the taxpayer acquired any mineral property under circumstances which make section 334 (b), 362 (a) and (b), 372 (a), 373 (b) (1), 723, 732, 1051, or 1082 apply to such transfer.

(d) ADJUSTED BASIS OF MINE OR DEPOSIT.—The amount of expenditures which are treated under subsection (b) as deferred expenses

shall be taken into account in computing the adjusted basis of the mine or deposit, but such amounts, and the adjustments to basis provided in section 1016 (a) (10) shall be disregarded in determining the adjusted basis of the property for the purpose of computing a deduction for depletion under section 611.

SEC. 616. DEVELOPMENT EXPENDITURES.

(a) IN GENERAL.—Except as provided in subsection (b), there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures.

(b) ELECTION OF TAXPAYER.—At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, expenditures described in subsection (a) paid or incurred during the taxable year shall be treated as deferred expenses and shall be deductible on a ratable basis as the units of produced ores or minerals benefited by such expenditures are sold. In the case of such expenditures paid or incurred during the development stage of the mine or deposit, the election shall apply only with respect to the excess of such expenditures during the taxable year over the net receipts during the taxable year from the ores or minerals produced from such mine or deposit. The election under this subsection, if made, must be for the total amount of such expenditures, or the total amount of such excess, as the case may be, with respect to the mine or deposit, and shall be binding for such taxable year.

(c) ADJUSTED BASIS OF MINE OR DEPOSIT.—The amount of expenditures which are treated under subsection (b) as deferred expenses shall be taken into account in computing the adjusted basis of the mine or deposit, except that such amount, and the adjustments to basis provided in section 1016 (a) (9), shall be disregarded in determining the adjusted basis of the property for the purpose of computing a deduction for depletion under section 611.

PART II—EXCLUSIONS FROM GROSS INCOME

Sec. 621. Payments to encourage exploration, development, and mining for defense purposes.

SEC. 621. PAYMENTS TO ENCOURAGE EXPLORATION, DEVELOPMENT, AND MINING FOR DEFENSE PURPOSES.

There shall not be included in gross income any amount paid to a taxpayer by the United States (or any agency or instrumentality thereof), whether by grant or loan, and whether or not repayable, for the encouragement of exploration, development, or mining of critical and strategic minerals or metals pursuant to or in connection with any undertaking approved by the United States (or any of its agencies or instrumentalities) and for which an accounting is made or required to be made to an appropriate governmental agency, or any forgiveness

or discharge of any part of such amount. Any expenditures (other than expenditures made after the repayment of such grant or loan) attributable to such grant or loan shall not be deductible by the taxpayer as an expense nor increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition or for computing depletion or depreciation, but on the repayment of any portion of any such grant or loan which has been expended in accordance with the terms thereof such deductions and such increase in basis shall to the extent of such repayment be allowed as if made at the time of such repayment.

PART III—SALES AND EXCHANGES

Sec. 631. Gain or loss in the case of timber or coal.
Sec. 632. Sale of oil or gas properties.

SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.

(a) ELECTION TO CONSIDER CUTTING AS SALE OR EXCHANGE.—If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months before the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary or his delegate, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary or his delegate. For purposes of this subsection and subsection (b), the term "timber" includes evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes.

(b) DISPOSAL OF TIMBER WITH A RETAINED ECONOMIC INTEREST.—In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable

with respect to rents and royalties shall be determined without regard to the provisions of this subsection. The date of disposal of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under the contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. For purposes of this subsection, the term "owner" means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

(c) DISPOSAL OF COAL WITH A RETAINED ECONOMIC INTEREST.—In the case of the disposal of coal (including lignite), held for more than 6 months before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal, the difference between the amount realized from the disposal of such coal and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal, and the word "owner" means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determinations of the amount of the deductions under section 535 (b) (6) or section 545 (b) (5)).

SEC. 632. SALE OF OIL OR GAS PROPERTIES.

In the case of a bona fide sale of any oil or gas property, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer, the portion of the surtax imposed by section 1 attributable to such sale shall not exceed 30 percent of the selling price of such property or interest.

Subchapter J—Estates, Trusts, Beneficiaries, and Decedents

Part I. Estates, trusts, and beneficiaries.
Part II. Income in respect of decedents.

PART I—ESTATES, TRUSTS, AND BENEFICIARIES

Subpart A. General rules for taxation of estates and trusts.
Subpart B. Trusts which distribute current income only.
Subpart C. Estates and trusts which may accumulate income or which distribute corpus.
Subpart D. Treatment of excess distributions by trusts.
Subpart E. Grantors and others treated as substantial owners.
Subpart F. Miscellaneous.

Subpart A—General Rules for Taxation of Estates and Trusts

Sec. 641. Imposition of tax.
Sec. 642. Special rules for credits and deductions.
Sec. 643. Definitions applicable to subparts A, B, C, and D.

SEC. 641. IMPOSITION OF TAX.

(a) APPLICATION OF TAX.—The taxes imposed by this chapter on individuals shall apply to the taxable income of estates or of any kind of property held in trust, including—

(1) income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;

(2) income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(3) income received by estates of deceased persons during the period of administration or settlement of the estate; and

(4) income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

(b) COMPUTATION AND PAYMENT.—The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS.

(a) CREDITS AGAINST TAX.—

(1) PARTIALLY TAX-EXEMPT INTEREST.—An estate or trust shall be allowed the credit against tax for partially tax-exempt interest provided by section 35 only in respect of so much of such interest as is not properly allocable to any beneficiary under section 652 or 662. If the estate or trust elects under section 171 to treat as amortizable the premium on bonds with respect to the interest on which the credit is allowable under section 35, such credit (whether

allowable to the estate or trust or to the beneficiary) shall be reduced under section 171 (a) (3).

(2) FOREIGN TAXES.—An estate or trust shall be allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States, to the extent allowed by section 901, only in respect of so much of the taxes described in such section as is not properly allocable under such section to the beneficiaries.

(3) DIVIDENDS RECEIVED BY INDIVIDUALS.—An estate or trust shall be allowed the credit against tax for dividends received provided by section 34 only in respect of so much of such dividends as is not properly allocable to any beneficiary under section 652 or 662. For purposes of determining the time of receipt of dividends under section 34 and section 116, the amount of dividends properly allocable to a beneficiary under section 652 or 662 shall be deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust.

(b) DEDUCTION FOR PERSONAL EXEMPTION.—An estate shall be allowed a deduction of $600. A trust which, under its governing instrument, is required to distribute all of its income currently shall be allowed a deduction of $300. All other trusts shall be allowed a deduction of $100. The deductions allowed by this subsection shall be in lieu of the deductions allowed under section 151 (relating to deduction for personal exemption).

(c) DEDUCTION FOR AMOUNTS PAID OR PERMANENTLY SET ASIDE FOR A CHARITABLE PURPOSE.—In the case of an estate or trust (other than a trust meeting the specifications of subpart B) there shall be allowed as a deduction in computing its taxable income (in lieu of the deductions allowed by section 170 (a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid or permanently set aside for a purpose specified in section 170 (c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit. For this purpose, to the extent that such amount consists of gain from the sale or exchange of capital assets held for more than 6 months, proper adjustment of the deduction otherwise allowable under this subsection shall be made for any deduction allowable to the estate or trust under section 1202 (relating to deduction for excess of capital gains over capital losses). In the case of a trust, the deduction allowed by this subsection shall be subject to section 681 (relating to unrelated business income and prohibited transactions).

(d) NET OPERATING LOSS DEDUCTION.—The benefit of the deduction for net operating losses provided by section 172 shall be allowed to estates and trusts under regulations prescribed by the Secretary or his delegate.

(e) DEDUCTION FOR DEPRECIATION AND DEPLETION.—An estate or trust shall be allowed the deduction for depreciation and depletion only to the extent not allowable to beneficiaries under sections 167 (g) and 611 (b).

(f) AMORTIZATION OF EMERGENCY OR GRAIN STORAGE FACILITIES.—The benefit of the deductions for amortization of emergency and grain storage facilities provided by sections 168 and 169 shall be allowed to estates and trusts in the same manner as in the case of an individual. The allowable deduction shall be apportioned between the income beneficiaries and the fiduciary under regulations prescribed by the Secretary or his delegate.

(g) DISALLOWANCE OF DOUBLE DEDUCTIONS.—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, unless there is filed, within the time and in the manner and form prescribed by the Secretary or his delegate, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect of decedents).

(h) UNUSED LOSS CARRYOVERS AND EXCESS DEDUCTIONS ON TERMINATION AVAILABLE TO BENEFICIARIES.—If on the termination of an estate or trust, the estate or trust has—

(1) a net operating loss carryover under section 172 or a capital loss carryover under section 1212, or

(2) for the last taxable year of the estate or trust deductions (other than the deductions allowed under subsections (b) or (c)) in excess of gross income for such year,

then such carryover or such excess shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary or his delegate, to the beneficiaries succeeding to the property of the estate or trust.

(i) CROSS REFERENCE.—

For disallowance of standard deduction in case of estates and trusts see section 142 (b) (4).

SEC. 643. DEFINITIONS APPLICABLE TO SUBPARTS A, B, C, AND D.

(a) DISTRIBUTABLE NET INCOME.—For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—

(1) DEDUCTION FOR DISTRIBUTIONS.—No deduction shall be taken under sections 651 and 661 (relating to additional deductions).

(2) DEDUCTION FOR PERSONAL EXEMPTION.—No deduction shall be taken under section 642 (b) (relating to deduction for personal exemptions).

(3) CAPITAL GAINS AND LOSSES.—Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642 (c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The

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deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

(4) EXTRAORDINARY DIVIDENDS AND TAXABLE STOCK DIVIDENDS.—For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

(5) TAX-EXEMPT INTEREST.—There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).

(6) FOREIGN INCOME.—In the case of a foreign trust, there shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265 (1) (relating to disallowance of certain deductions).

(7) DIVIDENDS.—There shall be included the amount of any dividends excluded from gross income pursuant to section 116 (relating to partial exclusion of dividends received).

If the estate or trust is allowed a deduction under section 642 (c), the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for the purposes specified in section 642 (c) is deemed to consist of items specified in those paragraphs. For this purpose, such amount shall (in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

(b) INCOME.—For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

(c) BENEFICIARY.—For purposes of this part, the term "beneficiary" includes heir, legatee, devisee.

Subpart B—Trusts Which Distribute Current Income Only

Sec. 651. Deduction for trusts distributing current income only.
Sec. 652. Inclusion of amounts in gross income of beneficiaries of trusts distributing current income only.

SEC. 651. DEDUCTION FOR TRUSTS DISTRIBUTING CURRENT INCOME ONLY.

(a) DEDUCTION.—In the case of any trust the terms of which—

(1) provide that all of its income is required to be distributed currently, and

(2) do not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in section 642 (c) (relating to deduction for charitable, etc., purposes),

there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently. This section shall not apply in any taxable year in which the trust distributes amounts other than amounts of income described in paragraph (1).

(b) LIMITATION ON DEDUCTION.—If the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, the deduction shall be limited to the amount of the distributable net income. For this purpose, the computation of distributable net income shall not include items of income which are not included in the gross income of the trust and the deductions allocable thereto.

SEC. 652. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF TRUSTS DISTRIBUTING CURRENT INCOME ONLY.

(a) INCLUSION.—Subject to subsection (b), the amount of income for the taxable year required to be distributed currently by a trust described in section 651 shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not. If such amount exceeds the distributable net income, there shall be included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries.

(b) CHARACTER OF AMOUNTS.—The amounts specified in subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate.

(c) DIFFERENT TAXABLE YEARS.—If the taxable year of a beneficiary is different from that of the trust, the amount which the bene-

ficiary is required to include in gross income in accordance with the provisions of this section shall be based upon the amount of income of the trust for any taxable year or years of the trust ending within or with his taxable year.

Subpart C—Estates and Trusts Which May Accumulate Income or Which Distribute Corpus

Sec. 661. Deductions for estates and trusts accumulating income or distributing corpus.
Sec. 662. Inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus.
Sec. 663. Special rules applicable to sections 661 and 662.

SEC. 661. DEDUCTION FOR ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS.

(a) DEDUCTION.—In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of—

(1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and

(2) any other amounts properly paid or credited or required to be distributed for such taxable year;

but such deduction shall not exceed the distributable net income of the estate or trust.

(b) CHARACTER OF AMOUNTS DISTRIBUTED.—The amount determined under subsection (a) shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642 (c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate.

(c) LIMITATION ON DEDUCTION.—No deduction shall be allowed under subsection (a) in respect of any portion of the amount allowed as a deduction under that subsection (without regard to this subsection) which is treated under subsection (b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust.

SEC. 662. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS.

(a) INCLUSION.—Subject to subsection (b), there shall be included in the gross income of a beneficiary to whom an amount specified in section 661 (a) is paid, credited, or required to be distributed (by an estate or trust described in section 661), the sum of the following amounts:

(1) AMOUNTS REQUIRED TO BE DISTRIBUTED CURRENTLY.—The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (computed without the deduction allowed by section 642 (c), relating to deduction for charitable, etc., purposes) of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries. For purposes of this section, the phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent such amount is paid out of income for such taxable year.

(2) OTHER AMOUNTS DISTRIBUTED.—All other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year. If the sum of—

(A) the amount of income for the taxable year required to be distributed currently to all beneficiaries, and

(B) all other amounts properly paid, credited, or required to be distributed to all beneficiaries

exceeds the distributable net income of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (reduced by the amounts specified in (A)) as the other amounts properly paid, credited or required to be distributed to the beneficiary bear to the other amounts properly paid, credited, or required to be distributed to all beneficiaries.

(b) CHARACTER OF AMOUNTS.—The amounts determined under subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642 (c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642 (c) which is not attributable to income of the taxable year.

(c) DIFFERENT TAXABLE YEARS.—If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be based on the

distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate or trust ending within or with his taxable year.

SEC. 663. SPECIAL RULES APPLICABLE TO SECTIONS 661 AND 662.

(a) EXCLUSIONS.—There shall not be included as amounts falling within section 661 (a) or 662 (a)—

(1) GIFTS, BEQUESTS, ETC.—Any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments. For this purpose an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money.

(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 section 681).

(3) DENIAL OF DOUBLE DEDUCTION.—Any amount paid, credited, or distributed in the taxable year, if section 651 or section 661 applied to such amount for a preceding taxable year of an estate or trust because credited or required to be distributed in such preceding taxable year.

(b) DISTRIBUTIONS IN FIRST SIXTY-FIVE DAYS OF TAXABLE YEAR.—

(1) GENERAL RULE.—If within the first 65 days of any taxable year of a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year.

(2) LIMITATION.—This subsection shall apply only to a trust—

(A) which was in existence prior to January 1, 1954,

(B) which, under the terms of its governing instrument, may not distribute in any taxable year amounts in excess of the income of the preceding taxable year, and

(C) on behalf of which the fiduciary elects to have this subsection apply.

The election authorized by subparagraph (C) shall be made for the first taxable year to which this part is applicable in accordance with such regulations as the Secretary or his delegate shall prescribe and shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). If such election is made with respect to a taxable year, this subsection shall apply to all amounts properly paid or credited within the first 65 days of all subsequent taxable years of such trust.

(c) SEPARATE SHARES TREATED AS SEPARATE TRUSTS.—For the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts. The existence of such substantially separate and independent shares and the manner of treatment as separate trusts,

including the application of subpart D, shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

Subpart D—Treatment of Excess Distributions by Trusts

Sec. 665. Definitions applicable to subpart D.
Sec. 666. Accumulation distribution allocated to 5 preceding years.
Sec. 667. Denial of refund to trust.
Sec. 668. Treatment of amounts deemed distributed in preceding years.

SEC. 665. DEFINITIONS APPLICABLE TO SUBPART D.

(a) UNDISTRIBUTED NET INCOME.—For purposes of this subpart, the term "undistributed net income" for any taxable year means the amount by which distributable net income of the trust for such taxable year exceeds the sum of—

(1) the amounts for such taxable year specified in paragraphs (1) and (2) of section 661 (a); and

(2) the amount of taxes imposed on the trust.

(b) ACCUMULATION DISTRIBUTION.—For purposes of this subpart, the term "accumulation distribution" for any taxable year of the trust means the amount (if in excess of $2,000) by which the amounts specified in paragraph (2) of section 661 (a) for such taxable year exceed distributable net income reduced by the amounts specified in paragraph (1) of section 661 (a). For purposes of this subsection, the amount specified in paragraph (2) of section 661 (a) shall be determined without regard to section 666 and shall not include—

(1) amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21;

(2) amounts properly paid or credited to a beneficiary to meet the emergency needs of such beneficiary;

(3) amounts properly paid or credited to a beneficiary upon such beneficiary's attaining a specified age or ages if—

(A) the total number of such distributions cannot exceed 4 with respect to such beneficiary,

(B) the period between each such distribution to such beneficiary is 4 years or more, and

(C) as of January 1, 1954, such distributions are required by the specific terms of the governing instrument; and

(4) amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution is made more than 9 years after the date of the last transfer to such trust.

(c) TAXES IMPOSED ON THE TRUST.—For purposes of this subpart, the term "taxes imposed on the trust" means the amount of the taxes which are imposed for any taxable year on the trust under this chapter (without regard to this subpart) and which, under regulations prescribed by the Secretary or his delegate, are properly allocable to the undistributed portion of the distributable net income. The amount determined in the preceding sentence shall be reduced by any amount of such taxes allowed, under sections 667 and 668, as a credit to any beneficiary on account of any accumulation distribution determined for any taxable year.

(d) PRECEDING TAXABLE YEAR.—For purposes of this subpart, the term "preceding taxable year" does not include any taxable year of the trust to which this part does not apply. In the case of a preceding taxable year with respect to which a trust qualifies (without regard to this subpart) under the provisions of subpart B, for purposes of the application of this subpart to such trust for such taxable year, such trust shall, in accordance with regulations prescribed by the Secretary or his delegate, be treated as a trust to which subpart C applies.

SEC. 666. ACCUMULATION DISTRIBUTION ALLOCATED TO 5 PRECEDING YEARS.

(a) AMOUNT ALLOCATED.—In the case of a trust which for a taxable year beginning after December 31, 1953, is subject to subpart C, the amount of the accumulation distribution of such trust for such taxable year shall be deemed to be an amount within the meaning of paragraph (2) of section 661 (a) distributed on the last day of each of the 5 preceding taxable years to the extent that such amount exceeds the total of any undistributed net incomes for any taxable years intervening between the taxable year with respect to which the accumulation distribution is determined and such preceding taxable year. The amount deemed to be distributed in any such preceding taxable year under the preceding sentence shall not exceed the undistributed net income of such preceding taxable year. For purposes of this subsection, undistributed net income for each of such 5 preceding taxable years shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

(b) TOTAL TAXES DEEMED DISTRIBUTED.—If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661 (a) distributed on the last day of any preceding taxable year, and such portion of such accumulation distribution is not less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661 (a). Such additional amount shall be equal to the taxes imposed on the trust for such preceding taxable year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

(c) PRO RATA PORTION OF TAXES DEEMED DISTRIBUTED.—If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661 (a) distributed on the last day of any preceding taxable year and such portion of the accumulation distribution is less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661 (a). Such additional amount shall be equal to the taxes imposed on the trust for such taxable year

multiplied by the ratio of the portion of the accumulation distribution to the undistributed net income of the trust for such year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year shall be computed without regard to the accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

SEC. 667. DENIAL OF REFUND TO TRUSTS.

The amount of taxes imposed on the trust under this chapter, which would not have been payable by the trust for any preceding taxable year had the trust in fact made distributions at the times and in the amounts deemed under section 666, shall not be refunded or credited to the trust, but shall be allowed as a credit under section 668 (b) against the tax of the beneficiaries who are treated as having received the distributions. For purposes of the preceding sentence, the amount of taxes which may not be refunded or credited to the trust shall be an amount equal to the excess of (1) the taxes imposed on the trust for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year) over (2) the amount of taxes for such preceding taxable year imposed on the undistributed portion of distributable net income of the trust for such preceding taxable year after the application of this subpart on account of the accumulation distribution determined for such taxable year.

SEC. 668. TREATMENT OF AMOUNTS DEEMED DISTRIBUTED IN PRECEDING YEARS.

(a) AMOUNTS TREATED AS RECEIVED IN PRIOR TAXABLE YEARS.—The total of the amounts which are treated under section 666 as having been distributed by the trust in a preceding taxable year shall be included in the income of a beneficiary or beneficiaries of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of such beneficiary or beneficiaries under section 662 (a) (2) and (b) if such total had been paid to such beneficiary or beneficiaries on the last day of such preceding taxable year. The portion of such total included under the preceding sentence in the income of any beneficiary shall be based upon the same ratio as determined under the second sentence of section 662 (a) (2) for the taxable year in respect of which the accumulation distribution is determined, except that proper adjustment of such ratio shall be made, in accordance with regulations prescribed by the Secretary or his delegate, for amounts which fall within paragraphs (1) through (4) of section 665 (b). The tax of the beneficiaries attributable to the amounts treated as having been received on the last day of such preceding taxable year of the trust shall not be greater than the aggregate of the taxes attributable to those amounts had they been included in the gross income of the beneficiaries on such day in accordance with section 662 (a) (2) and (b).

(b) CREDIT FOR TAXES PAID BY TRUST.—The tax imposed on beneficiaries under this chapter shall be credited with a pro rata portion of the taxes imposed on the trust under this chapter for such preceding taxable year which would not have been payable by the

trust for such preceding taxable year had the trust in fact made distributions to such beneficiaries at the times and in the amounts specified in section 666.

Subpart E—Grantors and Others Treated as Substantial Owners

Sec. 671. Trust income, deductions, and credits attributable to grantors and others as substantial owners.
Sec. 672. Definitions and rules.
Sec. 673. Reversionary interests.
Sec. 674. Power to control beneficial enjoyment.
Sec. 675. Administrative powers.
Sec. 676. Power to revoke.
Sec. 677. Income for benefit of grantor.
Sec. 678. Person other than grantor treated as substantial owner.

SEC. 671. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AND OTHERS AS SUBSTANTIAL OWNERS.

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

SEC. 672. DEFINITIONS AND RULES.

(a) ADVERSE PARTY.—For purposes of this subpart, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

(b) NONADVERSE PARTY.—For purposes of this subpart, the term "nonadverse party" means any person who is not an adverse party.

(c) RELATED OR SUBORDINATE PARTY.—For purposes of this subpart, the term "related or subordinate party" means any nonadverse party who is—

(1) the grantor's spouse if living with the grantor;

(2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

(d) RULE WHERE POWER IS SUBJECT TO CONDITION PRECEDENT.—A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

SEC. 673. REVERSIONARY INTERESTS.

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

(b) EXCEPTION WHERE INCOME IS PAYABLE TO CHARITABLE BENEFICIARIES.—Subsection (a) shall not apply to the extent that the income of a portion of a trust in which the grantor has a reversionary interest is, under the terms of the trust, irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary, which beneficiary is of a type described in section 170 (b) (1) (A) (i), (ii), or (iii).

(c) REVERSIONARY INTEREST TAKING EFFECT AT DEATH OF INCOME BENEFICIARY.—The grantor shall not be treated under subsection (a) as the owner of any portion of a trust where his reversionary interest in such portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income therefrom is payable.

(d) POSTPONEMENT OF DATE SPECIFIED FOR REACQUISITION.—Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

SEC. 674. POWER TO CONTROL BENEFICIAL ENJOYMENT.

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(b) EXCEPTIONS FOR CERTAIN POWERS.—Subsection (a) shall not apply to the following powers regardless of by whom held:

(1) POWER TO APPLY INCOME TO SUPPORT OF A DEPENDENT.—A power described in section 677 (b) to the extent that the grantor would not be subject to tax under that section.

(2) POWER AFFECTING BENEFICIAL ENJOYMENT ONLY AFTER EXPIRATION OF 10-YEAR PERIOD.—A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the

owner after the expiration of the period unless the power is relinquished.

(3) POWER EXERCISABLE ONLY BY WILL.—A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(4) POWER TO ALLOCATE AMONG CHARITABLE BENEFICIARIES.—A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contributions).

(5) POWER TO DISTRIBUTE CORPUS.—A power to distribute corpus either—

(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

(B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) POWER TO WITHHOLD INCOME TEMPORARILY.—A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable—

(A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries

designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) POWER TO WITHHOLD INCOME DURING DISABILITY OF A BENEFICIARY.—A power exercisable only during—

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(8) POWER TO ALLOCATE BETWEEN CORPUS AND INCOME.—A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

(c) EXCEPTION FOR CERTAIN POWERS OF INDEPENDENT TRUSTEES.—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor—

(1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

(2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(d) POWER TO ALLOCATE INCOME IF LIMITED BY A STANDARD.—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

SEC. 675. ADMINISTRATIVE POWERS.

The grantor shall be treated as the owner of any portion of a trust in respect of which—

(1) POWER TO DEAL FOR LESS THAN ADEQUATE AND FULL CONSIDERATION.—A power exercisable by the grantor or a nonadverse

party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) POWER TO BORROW WITHOUT ADEQUATE INTEREST OR SECURITY.—A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) BORROWING OF THE TRUST FUNDS.—The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.

(4) GENERAL POWERS OF ADMINISTRATION.—A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

SEC. 676. POWER TO REVOKE.

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

(b) POWER AFFECTING BENEFICIAL ENJOYMENT ONLY AFTER EXPIRATION OF 10-YEAR PERIOD.—Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the expiration of such period unless the power is relinquished.

SEC. 677. INCOME FOR BENEFIT OF GRANTOR.

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of

any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be—

(1) distributed to the grantor;

(2) held or accumulated for future distribution to the grantor; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(b) OBLIGATIONS OF SUPPORT.—Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661 (a) and shall be taxed to the grantor under section 662.

SEC. 678. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER.

(a) GENERAL RULE.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) EXCEPTION WHERE GRANTOR IS TAXABLE.—Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is otherwise treated as the owner under sections 671 to 677, inclusive.

(c) OBLIGATIONS OF SUPPORT.—Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661 (a) and shall be taxed to the holder of the power under section 662.

(d) EFFECT OF RENUNCIATION OR DISCLAIMER.—Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

Subpart F—Miscellaneous

Sec. 681. Limitation on charitable deduction.
Sec. 682. Income of an estate or trust in case of divorce, etc.
Sec. 683. Applicability of provisions.

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 leases).

(b) OPERATIONS OF TRUSTS.—

(1) LIMITATION ON CHARITABLE, ETC., DEDUCTION.—The amount otherwise allowable under section 642 (c) as a deduction shall not exceed 20 percent of the taxable income of the trust (computed without the benefit of section 642 (c) but with the benefit of section 170 (b) (1) (A)) if the trust has engaged in a prohibited transaction, as defined in paragraph (2).

(2) PROHIBITED TRANSACTIONS.—For purposes of this subsection, the term "prohibited transaction" means any transaction after July 1, 1950, in which any trust while holding income or corpus which has been permanently set aside or is to be used exclusively for charitable or other purposes described in section 642 (c)—

(A) lends any part of such income or corpus, without receipt of adequate security and a reasonable rate of interest, to;

(B) pays any compensation from such income or corpus, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(C) makes any part of its services available on a preferential basis to;

(D) uses such income or corpus to make any substantial purchase of securities or any other property, for more than an adequate consideration in money or money's worth, from;

(E) sells any substantial part of the securities or other property comprising such income or corpus, for less than an adequate consideration in money or money's worth, to; or

(F) engages in any other transaction which results in a substantial diversion of such income or corpus to;

the creator of such trust; any person who has made a substantial contribution to such trust; a member of a family (as defined in section 267 (c) (4)) of an individual who is the creator of the trust or who has made a substantial contribution to the trust; or a cor-

poration controlled by any 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.

(3) TAXABLE YEARS AFFECTED.—The amount otherwise allowable under section 642 (c) as a deduction shall be limited as provided in paragraph (1) only for taxable years after the taxable year during which the trust is notified by the Secretary that it has engaged in such transaction, unless such trust entered into such prohibited transaction with the purpose of diverting such corpus or income from the purposes described in section 642 (c), and such transaction involved a substantial part of such corpus or income.

(4) FUTURE CHARITABLE, ETC., DEDUCTIONS OF TRUSTS DENIED DEDUCTION UNDER PARAGRAPH (3).—If the deduction of any trust under section 642 (c) has been limited as provided in this subsection, such trust, with respect to any taxable year following the taxable year in which notice is received of limitation of deduction under section 642 (c), may, under regulations prescribed by the Secretary or his delegate, file claim for the allowance of the unlimited deduction under section 642 (c), and if the Secretary, pursuant to such regulations, is satisfied that such trust will not knowingly again engage in a prohibited transaction, the limitation provided in paragraph (1) shall not apply with respect to taxable years after the year in which such claim is filed.

(5) DISALLOWANCE OF CERTAIN CHARITABLE, ETC., DEDUCTIONS.—No gift or bequest for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals), otherwise allowable as a deduction under section 170, 545 (b) (2), 642 (c), 2055, 2106 (a) (2), or 2522, shall be allowed as a deduction if made in trust and, in the taxable year of the trust in which the gift or bequest is made, the deduction allowed the trust under section 642 (c) is limited by paragraph (1). With respect to any taxable year of a trust in which such deduction has been so limited by reason of entering into a prohibited transaction with the purpose of diverting such corpus or income from the purposes described in section 642 (c), and such transaction involved a substantial part of such income or corpus, and which taxable year is the same, or before the, taxable year of the trust in which such prohibited transaction occurred, such deduction shall be disallowed the donor only if such donor or (if such donor is an individual) any member of his family (as defined in section 267 (c) (4)) was a party to such prohibited transaction.

(6) DEFINITION.—For purposes of this subsection, the term "gift or bequest" means any gift, contribution, bequest, devise, or legacy, or any transfer without adequate consideration.

(c) ACCUMULATED INCOME.—If the amounts permanently set aside, or to be used exclusively for the charitable and other purposes described in section 642 (c) during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out such purposes of the trust;

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(2) are used to a substantial degree for purposes other than those prescribed in section 642 (c); or

(3) are invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries,

the amount otherwise allowable under section 642 (c) as a deduction shall be limited to the amount actually paid out during the taxable year and shall not exceed 20 percent of the taxable income of the trust (computed without the benefit of section 642 (c) but with the benefit of section 170 (b) (1) (A)). Paragraph (1) shall not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. In the case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, paragraph (1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

(d) CROSS REFERENCE.—

For disallowance of certain charitable, etc., deductions otherwise allowable under section 642 (c), see section 503 (e).

SEC. 682. INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE, ETC.

(a) INCLUSION IN GROSS INCOME OF WIFE.—There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is separated from her husband under a written separation agreement) the amount of the income of any trust which such wife is entitled to receive and which, except for this section, would be includible in the gross income of her husband, and such amount shall not, despite any other provision of this subtitle, be includible in the gross income of such husband. This subsection shall not apply to that part of any such income of the trust which the terms of the decree, written separation agreement, or trust instrument fix, in terms of an amount of money or a portion of such income, as a sum which is payable for the support of minor children of such husband. In case such income is less than the amount specified in the decree, agreement, or instrument, for the purpose of applying the preceding sentence, such income, to the extent of such sum payable for such support, shall be considered a payment for such support.

(b) WIFE CONSIDERED A BENEFICIARY.—For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) or section 71 applies, such wife shall be considered as the beneficiary specified in this part. A periodic payment under section 71 to any portion of which this part applies shall be included in the gross income of the beneficiary in the taxable year in which under this part such portion is required to be included.

(c) CROSS REFERENCE.—

For definitions of "husband" and "wife", as used in this section, see section 7701 (a) (17).

SEC. 683. APPLICABILITY OF PROVISIONS.

(a) GENERAL RULE.—This part shall apply only to taxable years beginning after December 31, 1953, and ending after the date of the enactment of this title.

(b) EXCEPTIONS.—In the case of any beneficiary of an estate or trust—

(1) this part shall not apply to any amount paid, credited, or to be distributed by the estate or trust in any taxable year of such estate or trust to which this part does not apply, and

(2) the Internal Revenue Code of 1939 shall apply for purposes of determining the amount includible in the gross income of the beneficiary.

To the extent that any amount paid, credited, or to be distributed by an estate or trust in the first taxable year of such estate or trust to which this part applies would be treated, if the Internal Revenue Code of 1939 were applicable, as paid, credited, or to be distributed on the last day of the preceding taxable year, such amount shall not be taken into account for purposes of this part but shall be taken into account as provided in the Internal Revenue Code of 1939.

PART II—INCOME IN RESPECT OF DECEDENTS

Sec. 691. Recipients of income in respect of decedents.
Sec. 692. Income taxes of members of Armed Forces on death.

SEC. 691. RECIPIENTS OF INCOME IN RESPECT OF DECEDENTS.

(a) INCLUSION IN GROSS INCOME.—

(1) GENERAL RULE.—The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:

(A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

(2) INCOME IN CASE OF SALE, ETC.—If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration

for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

(3) CHARACTER OF INCOME DETERMINED BY REFERENCE TO DECEDENT.—The right, described in paragraph (1), to receive an amount shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income under paragraph (1) or (2) shall be considered in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount.

(4) INSTALLMENT OBLIGATIONS ACQUIRED FROM DECEDENT.—In the case of an installment obligation received by a decedent on the sale or other disposition of property, the income from which was properly reportable by the decedent on the installment basis under section 453, if such obligation is acquired by the decedent's estate from the decedent or by any person by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent—

(A) an amount equal to the excess of the face amount of such obligation over the basis of the obligation in the hands of the decedent (determined under section 453 (d)) shall, for the purpose of paragraph (1), be considered as an item of gross income in respect of the decedent; and

(B) such obligation shall, for purposes of paragraphs (2) and (3), be considered a right to receive an item of gross income in respect of the decedent, but the amount includible in gross income under paragraph (2) shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453 (d)).

(b) ALLOWANCE OF DEDUCTIONS AND CREDIT.—The amount of any deduction specified in section 162, 163, 164, 212, or 611 (relating to deductions for expenses, interest, taxes, and depletion) or credit specified in section 33 (relating to foreign tax credit), in respect of a decedent which is not properly allowable to the decedent in respect of the taxable period in which falls the date of his death, or a prior period, shall be allowed:

(1) EXPENSES, INTEREST, AND TAXES.—In the case of a deduction specified in section 162, 163, 164, or 212 and a credit specified in section 33, in the taxable year when paid—

(A) to the estate of the decedent; except that

(B) if the estate of the decedent is not liable to discharge the obligation to which the deduction or credit relates, 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.

(2) DEPLETION.—In the case of the deduction specified in section 611, to the person described in subsection (a) (1) (A), (B), or (C) who, in the manner described therein, receives the income to which the deduction relates, in the taxable year when such income is received.

(c) DEDUCTION FOR ESTATE TAX.—

(1) ALLOWANCE OF DEDUCTION.—

(A) GENERAL RULE.—A person who includes an amount in gross income under subsection (a) shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all the items described in subsection (a) (1) as the value for estate tax purposes of the items of gross income or portions thereof in respect of which such person included the amount in gross income (or the amount included in gross income, whichever is lower) bears to the value for estate tax purposes of all the items described in subsection (a) (1).

(B) ESTATES AND TRUSTS.—In the case of an estate or trust, the amount allowed as a deduction under subparagraph (A) shall be computed by excluding from the gross income of the estate or trust the portion (if any) of the items described in subsection (a) (1) which is properly paid, credited, or to be distributed to the beneficiaries during the taxable year. This subparagraph shall apply to the same taxable years, and to the same extent, as is provided in section 683.

(2) METHOD OF COMPUTING DEDUCTION.—For purposes of paragraph (1)—

(A) The term "estate tax" means the tax imposed on the estate of the decedent or any prior decedent under section 2001 or 2101, reduced by the credits against such tax.

(B) The net value for estate tax purposes of all the items described in subsection (a) (1) shall be the excess of the value for estate tax purposes of all the items described in subsection (a) (1) over the deductions from the gross estate in respect of claims which represent the deductions and credit described in subsection (b). Such net value shall be determined with regard to the provisions of section 421 (d) (6) (B), relating to the deduction for estate tax with respect to restricted stock options.

(C) The estate tax attributable to such net value shall be an amount equal to the excess of the estate tax over the estate tax computed without including in the gross estate such net value.

(d) AMOUNTS RECEIVED BY SURVIVING ANNUITANT UNDER JOINT AND SURVIVOR ANNUITY CONTRACT.—

(1) DEDUCTION FOR ESTATE TAX.—For purposes of computing the deduction under subsection (c) (1) (A), amounts received by a surviving annuitant—

(A) as an annuity under a joint and survivor annuity contract where the decedent annuitant died after December 31, 1953, and after the annuity starting date (as defined in section 72 (c) (4)), and

(B) during the surviving annuitant's life expectancy period, shall, to the extent included in gross income under section 72, be considered as amounts included in gross income under subsection (a).

(2) NET VALUE FOR ESTATE TAX PURPOSES.—In determining the net value for estate tax purposes under subsection (c) (2) (B) for purposes of this subsection, the value for estate tax purposes of the items described in paragraph (1) of this subsection shall be computed—

(A) by determining the excess of the value of the annuity at the date of the death of the deceased annuitant over the total amount excludable from the gross income of the surviving annuitant under section 72 during the surviving annuitant's life expectancy period, and

(B) by multiplying the figure so obtained by the ratio which the value of the annuity for estate tax purposes bears to the value of the annuity at the date of the death of the deceased.

(3) DEFINITIONS.—For purposes of this subsection—

(A) The term "life expectancy period" means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant. For purposes of this subparagraph, the life expectancy of the surviving annuitant shall be determined, as of the date of the death of the deceased annuitant, with reference to actuarial tables prescribed by the Secretary or his delegate.

(B) The surviving annuitant's expected return under the contract shall be computed, as of the death of the deceased annuitant, with reference to actuarial tables prescribed by the Secretary or his delegate.

(e) CROSS REFERENCE.—

For application of this section to income in respect of a deceased partner, see section 753.

SEC. 692. INCOME TAXES ON MEMBERS OF ARMED FORCES ON DEATH.

In the case of any individual who dies during an induction period (as defined in section 112 (c) (5)) 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.

Subchapter K—Partners and Partnerships

Part I. Determination of tax liability.
Part II. Contributions, distributions, and transfers.
Part III. Definitions.
Part IV. Effective date for subchapter.

PART I—DETERMINATION OF TAX LIABILITY

Sec. 701. Partners, not partnership, subject to tax.
Sec. 702. Income and credits of partner.
Sec. 703. Partnership computations.
Sec. 704. Partner's distributive share.
Sec. 705. Determination of basis of partner's interest.
Sec. 706. Taxable years of partner and partnership.
Sec. 707. Transactions between partner and partnership.
Sec. 708. Continuation of partnership.

SEC. 701. PARTNERS, NOT PARTNERSHIP, SUBJECT TO TAX.

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) GENERAL RULE.—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

(1) gains and losses from sales or exchanges of capital assets held for not more than 6 months,

(2) gains and losses from sales or exchanges of capital assets held for more than 6 months,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) charitable contributions (as defined in section 170 (c)),

(5) dividends with respect to which there is provided a credit under section 34, an exclusion under section 116, or a deduction under part VIII of subchapter B,

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) partially tax-exempt interest on obligations of the United States or on obligations of instrumentalities of the United States as described in section 35 or section 242 (but, if the partnership elects to amortize the premiums on bonds as provided in section 171, the amount received on such obligations shall be reduced by the reduction provided under section 171 (a) (3)),

(8) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary or his delegate, and

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

(b) CHARACTER OF ITEMS CONSTITUTING DISTRIBUTIVE SHARE.—The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

(c) GROSS INCOME OF A PARTNER.—In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

SEC. 703. PARTNERSHIP COMPUTATIONS.

(a) INCOME AND DEDUCTIONS.—The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—

(1) the items described in section 702 (a) shall be separately stated, and

(2) the following deductions shall not be allowed to the partnership:

(A) the standard deduction provided in section 141,

(B) the deductions for personal exemptions provided in section 151,

(C) the deduction for taxes provided in section 164 (a) with respect to taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(D) the deduction for charitable contributions provided in section 170,

(E) the net operating loss deduction provided in section 172, and

(F) the additional itemized deductions for individuals provided in part VII of subchapter B (sec. 211 and following).

(b) ELECTIONS OF THE PARTNERSHIP.—Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that the election under section 901, relating to taxes of foreign countries and possessions of the United States, shall be made by each partner separately.

SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) DISTRIBUTIVE SHARE DETERMINED BY INCOME OR LOSS RATIO.—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702 (a) (9), for the taxable year, if—

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

(c) CONTRIBUTED PROPERTY.—

(1) GENERAL RULE.—In determining a partner's distributive share of items described in section 702 (a), depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, except to the extent otherwise provided in paragraph (2) or (3), be allocated among the partners in the same manner as if such property had been purchased by the partnership.

(2) EFFECT OF PARTNERSHIP AGREEMENT.—If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary or his delegate, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

(3) UNDIVIDED INTERESTS.—If the partnership agreement does not provide otherwise, depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. This paragraph shall apply only if all the partners had undivided interests in such property prior to contribution and their interests in the capital and profits of the partnership correspond with such undivided interests.

(d) LIMITATION ON ALLOWANCE OF LOSSES.—A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

(e) FAMILY PARTNERSHIPS.—

(1) RECOGNITION OF INTEREST CREATED BY PURCHASE OR GIFT.—A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

(2) DISTRIBUTIVE SHARE OF DONEE INCLUDIBLE IN GROSS INCOME.—In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(3) PURCHASE OF INTEREST BY MEMBER OF FAMILY.—For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

SEC. 705. DETERMINATION OF BASIS OF PARTNER'S INTEREST.

(a) GENERAL RULE.—The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)—

(1) increased by the sum of his distributive share for the taxable year and prior taxable years of—

(A) taxable income of the partnership as determined under section 703 (a),

(B) income of the partnership exempt from tax under this title, and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion; and

(2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of—

(A) losses of the partnership, and

(B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

(b) ALTERNATIVE RULE.—The Secretary or his delegate shall prescribe by regulations the circumstances under which the adjusted basis of a partner's interest in a partnership may be determined by reference to his proportionate share of the adjusted basis of partnership property upon a termination of the partnership.

SEC. 706. TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

(a) YEAR IN WHICH PARTNERSHIP INCOME IS INCLUDIBLE.—In computing the taxable income of a partner for a taxable year, the inclusions required by section 702 and section 707 (c) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner.

(b) ADOPTION OF TAXABLE YEAR.—

(1) PARTNERSHIP'S TAXABLE YEAR.—The taxable year of a partnership shall be determined as though the partnership were a taxpayer. A partnership may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary or his delegate, a business purpose therefor.

(2) PARTNER'S TAXABLE YEAR.—A partner may not change to a taxable year other than that of a partnership in which he is a principal partner unless he establishes, to the satisfaction of the Secretary or his delegate, a business purpose therefor.

(3) PRINCIPAL PARTNER.—For the purpose of this subsection, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(c) CLOSING OF PARTNERSHIP YEAR.—

(1) GENERAL RULE.—Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the

liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.

(2) PARTNER WHO RETIRES OR SELLS INTEREST IN PARTNERSHIP.—

(A) DISPOSITION OF ENTIRE INTEREST.—The taxable year of a partnership shall close—

(i) with respect to a partner who sells or exchanges his entire interest in a partnership, and

(ii) with respect to a partner whose interest is liquidated, except that the taxable year of a partnership with respect to a partner who dies shall not close prior to the end of the partnership's taxable year.

Such partner's distributive share of items described in section 702 (a) for such year shall be determined, under regulations prescribed by the Secretary or his delegate, for the period ending with such sale, exchange, or liquidation.

(B) DISPOSITION OF LESS THAN ENTIRE INTEREST.—The taxable year of a partnership shall not close (other than at the end of a partnership's taxable year as determined under subsection (b) (1)) with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced, but such partner's distributive share of items described in section 702 (a) shall be determined by taking into account his varying interests in the partnership during the taxable year.

SEC. 707. TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP.

(a) PARTNER NOT ACTING IN CAPACITY AS PARTNER.—If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(b) CERTAIN SALES OR EXCHANGES OF PROPERTY WITH RESPECT TO CONTROLLED PARTNERSHIPS.—

(1) LOSSES DISALLOWED.—No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between—

(A) a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or

(B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

In the case of a subsequent sale or exchange by a transferee described in this paragraph, section 267 (d) shall be applicable as if the loss were disallowed under section 267 (a) (1).

(2) GAINS TREATED AS ORDINARY INCOME.—In the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221—

(A) between a partnership and a partner owning, directly or indirectly, more than 80 percent of the capital interest, or profits interest, in such partnership, or

(B) between two partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interests or profits interests,

any gain recognized shall be considered as gain from the sale or exchange of property other than a capital asset.

(3) OWNERSHIP OF A CAPITAL OR PROFITS INTEREST.—For purposes of paragraphs (1) and (2) of this subsection, the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267 (c) other than paragraph (3) of such section.

(c) GUARANTEED PAYMENTS.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61 (a) (relating to gross income) and section 162 (a) (relating to trade or business expenses).

SEC. 708. CONTINUATION OF PARTNERSHIP.

(a) GENERAL RULE.—For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) TERMINATION.—

(1) GENERAL RULE.—For purposes of subsection (a), a partnership shall be considered as terminated only if—

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

(2) SPECIAL RULES.—

(A) MERGER OR CONSOLIDATION.—In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

(B) DIVISION OF A PARTNERSHIP.—In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall, for purposes of this section, be considered a continuation of the prior partnership.

PART II—CONTRIBUTIONS, DISTRIBUTIONS, AND TRANSFERS

Subpart A—Contributions to a partnership.
Subpart B—Distributions by a partnership.
Subpart C—Transfers of interests in a partnership.
Subpart D—Provisions common to other subparts.

Subpart A—Contributions to a Partnership

Sec. 721. Nonrecognition of gain or loss on contribution.
Sec. 722. Basis of contributing partner's interest.
Sec. 723. Basis of property contributed to partnership.

SEC. 721. NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION.

No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

SEC. 722. BASIS OF CONTRIBUTING PARTNER'S INTEREST.

The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution.

SEC. 723. BASIS OF PROPERTY CONTRIBUTED TO PARTNERSHIP.

The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution.

Subpart B—Distributions by a Partnership

Sec. 731. Extent of recognition of gain or loss on distribution.
Sec. 732. Basis of distributed property other than money.
Sec. 733. Basis of distributee partner's interest.
Sec. 734. Optional adjustment to basis of undistributed partnership property.
Sec. 735. Character of gain or loss on disposition of distributed property.
Sec. 736. Payments to a retiring partner or a deceased partner's successor in interest.

SEC. 731. EXTENT OF RECOGNITION OF GAIN OR LOSS ON DISTRIBUTION.

(a) PARTNERS.—In the case of a distribution by a partnership to a partner—

(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

(2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of—

(A) any money distributed, and

(B) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751 (c)) and inventory (as defined in section 751 (d) (2)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

(b) PARTNERSHIPS.—No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

(c) EXCEPTIONS.—This section shall not apply to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items).

SEC. 732. BASIS OF DISTRIBUTED PROPERTY OTHER THAN MONEY.

(a) DISTRIBUTIONS OTHER THAN IN LIQUIDATION OF A PARTNER'S INTEREST.—

(1) GENERAL RULE.—The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution.

(2) LIMITATION.—The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(b) DISTRIBUTIONS IN LIQUIDATION.—The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(c) ALLOCATION OF BASIS.—The basis of distributed properties to which subsection (a) (2) or subsection (b) is applicable shall be allotated—

(1) first to any unrealized receivables (as defined in section 751 (c)) and inventory items (as defined in section 751 (d) (2)) in an amount equal to the adjusted basis of each such property to the partnership (or if the basis to be allocated is less than the sum of the adjusted bases of such properties to the partnership, in proportion to such bases), and

(2) to the extent of any remaining basis, to any other distributed properties in proportion to their adjusted bases to the partnership.

(d) SPECIAL PARTNERSHIP BASIS TO TRANSFEREE.—For purposes of subsections (a), (b), and (c), a partner who acquired all or a part of his interest by a transfer with respect to which the election provided in section 754 is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within 2 years after such transfer, may elect, under regulations prescribed by the Secretary or his delegate, to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743 (b) were in effect with respect to the partnership property. The Secretary or his delegate may by regulations require the application of this subsection in the case of a distribution to a transferee partner, whether or not made within 2 years after the transfer, if at the time of the transfer the fair

market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(e) EXCEPTION.—This section shall not apply to the extent that a distribution is treated as a sale or exchange of property under section 751 (b) (relating to unrealized receivables and inventory items).

SEC. 733. BASIS OF DISTRIBUTEE PARTNER'S INTEREST.

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by—

(1) the amount of any money distributed to such partner, and

(2) the amount of the basis to such partner of distributed property other than money, as determined under section 732.

SEC. 734. OPTIONAL ADJUSTMENT TO BASIS OF UNDISTRIBUTED PARTNERSHIP PROPERTY.

(a) GENERAL RULE.—The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in section 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to such partnership.

(b) METHOD OF ADJUSTMENT.—In the case of a distribution of property to a partner, a partnership, with respect to which the election provided in section 754 is in effect, shall—

(1) increase the adjusted basis of partnership property by—

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731 (a) (1), and

(B) in the case of distributed property to which section 732 (a) (2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732 (d)) over the basis of the distributed property to the distributee, as determined under section 732, or

(2) decrease the adjusted basis of partnership property by—

(A) the amount of any loss recognized to the distributee partner with respect to such distribution under section 731 (a) (2), and

(B) in the case of distributed property to which section 732 (b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by section 732 (d)).

(c) ALLOCATION OF BASIS.—The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755.

SEC. 735. CHARACTER OF GAIN OR LOSS ON DISPOSITION OF DISTRIBUTED PROPERTY.

(a) SALE OR EXCHANGE OF CERTAIN DISTRIBUTED PROPERTY.—

(1) UNREALIZED RECEIVABLES.—Gain or loss on the disposition by a distributee partner of unrealized receivables (as defined in section 751 (c)) distributed by a partnership, shall be considered

gain or loss from the sale or exchange of property other than a capital asset.

(2) INVENTORY ITEMS.—Gain or loss on the sale or exchange by a distributee partner of inventory items (as defined in section 751 (d) (2)) distributed by a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered gain or loss from the sale or exchange of property other than a capital asset.

(b) HOLDING PERIOD FOR DISTRIBUTED PROPERTY.—In determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of subsection (a) (2)), there shall be included the holding period of the partnership, as determined under section 1223, with respect to such property.

SEC. 736. PAYMENTS TO A RETIRING PARTNER OR A DECEASED PARTNER'S SUCCESSOR IN INTEREST.

(a) PAYMENTS CONSIDERED AS DISTRIBUTIVE SHARE OR GUARANTEED PAYMENT.—Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707 (c) if the amount thereof is determined without regard to the income of the partnership.

(b) PAYMENTS FOR INTEREST IN PARTNERSHIP.—

(1) GENERAL RULE.—Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary or his delegate, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) SPECIAL RULES.—For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for—

(A) unrealized receivables of the partnership (as defined in section 751 (c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

Subpart C—Transfers of Interests in a Partnership

Sec. 741. Recognition and character of gain or loss on sale or exchange.
Sec. 742. Basis of transferee partner's interest.
Sec. 743. Optional adjustment to basis of partnership property.

SEC. 741. RECOGNITION AND CHARACTER OF GAIN OR LOSS ON SALE OR EXCHANGE.

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such 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 which have appreciated substantially in value).

SEC. 742. BASIS OF TRANSFEREE PARTNER'S INTEREST.

The basis of an interest in a partnership acquired other than by contribution shall be determined under part II of subchapter O (sec. 1011 and following).

SEC. 743. OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.

(a) GENERAL RULE.—The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

(b) ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.—In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect shall—

(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or

(2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Under regulations prescribed by the Secretary or his delegate, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of an agreement described in section 704 (c) (2) (relating to effect of partnership agreement on contributed property), such share shall be determined by taking such agreement into account. In the case of an adjustment under this subsection to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property.

(c) ALLOCATION OF BASIS.—The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755.

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Subpart D—Provisions Common to Other Subparts

Sec. 751. Unrealized receivables and inventory items.
Sec. 752. Treatment of certain liabilities.
Sec. 753. Partner receiving income in respect of decedent.
Sec. 754. Manner of electing optional adjustment to basis of partnership property.
Sec. 755. Rules for allocation of basis.

SEC. 751. UNREALIZED RECEIVABLES AND INVENTORY ITEMS.

(a) SALE OR EXCHANGE OF INTEREST IN PARTNERSHIP.—The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to—

(1) unrealized receivables of the partnership, or

(2) inventory items of the partnership which have appreciated substantially in value,

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

(b) CERTAIN DISTRIBUTIONS TREATED AS SALES OR EXCHANGES.—

(1) GENERAL RULE.—To the extent a partner receives in a distribution—

(A) partnership property described in subsection (a) (1) or (2) in exchange for all or a part of his interest in other partnership property (including money), or

(B) partnership property (including money) other than property described in subsection (a) (1) or (2) in exchange for all or a part of his interest in partnership property described in subsection (a) (1) or (2),

such transactions shall, under regulations prescribed by the Secretary or his delegate, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

(2) EXCEPTIONS.—Paragraph (1) shall not apply to—

(A) a distribution of property which the distributee contributed to the partnership, or

(B) payments, described in section 736 (a), to a retiring partner or successor in interest of a deceased partner.

(c) UNREALIZED RECEIVABLES.—For purposes of this subchapter, the term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for—

(1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(2) services rendered, or to be rendered.

(d) INVENTORY ITEMS WHICH HAVE APPRECIATED SUBSTANTIALLY IN VALUE.—

(1) SUBSTANTIAL APPRECIATION.—Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair market value exceeds—

(A) 120 percent of the adjusted basis to the partnership of such property, and

(B) 10 percent of the fair market value of all partnership property, other than money.

(2) INVENTORY ITEMS.—For purposes of this subchapter the term "inventory items" means—

(A) property of the partnership of the kind described in section 1221 (1),

(B) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231, and

(C) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in subparagraph (A) or (B).

SEC. 752. TREATMENT OF CERTAIN LIABILITIES.

(a) INCREASE IN PARTNER'S LIABILITIES.—Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) DECREASE IN PARTNER'S LIABILITIES.—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) LIABILITY TO WHICH PROPERTY IS SUBJECT.—For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) SALE OR EXCHANGE OF AN INTEREST.—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 or exchange of property not associated with partnerships.

SEC. 753. PARTNER RECEIVING INCOME IN RESPECT OF DECEDENT.

The amount includible in the gross income of a successor in interest of a deceased partner under section 736 (a) shall be considered income in respect of a decedent under section 691.

SEC. 754. MANNER OF ELECTING OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.

If a partnership files an election, in accordance with regulations prescribed by the Secretary or his delegate, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary or his delegate.

SEC. 755. RULES FOR ALLOCATION OF BASIS.

(a) GENERAL RULE.—Any increase or decrease in the adjusted basis of partnership property under section 734 (b) (relating to the optional adjustment to the basis of undistributed partnership property) or section 743 (b) (relating to the optional adjustment to the basis of partnership property in the case of a transfer of an interest in a partnership) shall, except as provided in subsection (b), be allocated—

(1) in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties, or

(2) in any other manner permitted by regulations prescribed by the Secretary or his delegate.

(b) SPECIAL RULE.—In applying the allocation rules provided in subsection (a), increases or decreases in the adjusted basis of partnership property arising from a distribution of, or a transfer of an interest attributable to, property consisting of—

(1) capital assets and property described in section 1231 (b), or

(2) any other property of the partnership,

shall be allocated to partnership property of a like character except that the basis of any such partnership property shall not be reduced below zero. If, in the case of a distribution, the adjustment to basis of property described in paragraph (1) or (2) is prevented by the absence of such property or by insufficient adjusted basis for such property, such adjustment shall be applied to subsequently acquired property of a like character in accordance with regulations prescribed by the Secretary or his delegate.

PART III—DEFINITIONS

Sec. 761. Terms defined.

SEC. 761. TERMS DEFINED.

(a) PARTNERSHIP.—For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary or his delegate may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of—

(1) for investment purposes only and not for the active conduct of a business, or

(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

(b) PARTNER.—For purposes of this subtitle, the term "partner" means a member of a partnership.

(c) PARTNERSHIP AGREEMENT.—For purposes of this subchapter, a partnership agreement includes any modifications of the partnership

agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

(d) LIQUIDATION OF A PARTNER'S INTEREST.—For purposes of this subchapter, the term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership.

PART IV—EFFECTIVE DATE FOR SUBCHAPTER

Sec. 771. Effective date.

SEC. 771. EFFECTIVE DATE.

(a) GENERAL RULE.—

(1) TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1954.—Except as provided in subsection (b), this subchapter shall apply with respect to—

(A) any partnership taxable year beginning after December 31, 1954, and

(B) any part of a partner's taxable year falling within such partnership taxable year.

(2) APPLICATION OF PRIOR PROVISIONS.—Except as provided in subsection (b), sections 113 (a) (13), 181 to 191 (inclusive), and 3797 (a) (2) of the Internal Revenue Code of 1939 shall apply with respect to—

(A) any partnership taxable year beginning before January 1, 1955, and

(B) any part of a partner's taxable year falling within such partnership taxable year.

(b) SPECIAL RULES.—

(1) ADOPTION OF TAXABLE YEAR.—Section 706 (b) (relating to the adoption of a taxable year by a partnership or partner) shall apply to—

(A) any partnership which adopts, or changes to, a taxable year beginning after April 1, 1954, and

(B) any partner who changes to a taxable year beginning after April 1, 1954.

For the purpose of applying this paragraph, section 708 (relating to the continuation of a partnership) shall be effective for taxable years beginning after April 1, 1954.

(2) PROPERTY DISTRIBUTED BY A PARTNERSHIP.—Section 735 (a) (relating to the character of gain or loss on the disposition of property distributed by a partnership) shall apply only to property distributed by a partnership after March 9, 1954.

(3) UNREALIZED RECEIVABLES AND INVENTORY ITEMS.—Section 751 (relating to unrealized receivables and inventory items) shall apply with respect to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, the other

sections of this subchapter shall be applicable to the extent provided by regulations prescribed by the Secretary or his delegate.

(4) PARTNER RECEIVING INCOME IN RESPECT OF DECEDENT.—Section 753 (relating to income in respect of a decedent) shall apply only in the case of payments made with respect to decedents dying after December 31, 1954.

(c) OPTIONAL TREATMENT OF CERTAIN DISTRIBUTIONS.—In the case of a partnership taxable year beginning after December 31, 1953, and before January 1, 1955, a partnership may elect, under regulations prescribed by the Secretary or his delegate, with respect to distributions made during such year to any partner, other than in liquidation of the partner's interest, to apply the rules in sections 731, 732 (a), (c), and (e), 733, 735, and 751 (b), (c), and (d) (and, to the extent applicable, the rules provided in sections 705, 752, and 761 (d)). If a partnership so elects, such rules shall be effective for the partnership and all members of such partnership with respect to such distributions.

Subchapter L—Insurance Companies

Part I. Life insurance companies.
Part II. Mutual insurance companies (other than life or marine or fire insurance companies issuing perpetual policies).
Part III. Other insurance companies.
Part IV. Provisions of general application.

PART I—LIFE INSURANCE COMPANIES

Sec. 801. Definition of life insurance company.
Sec. 802. Imposition of tax.
Sec. 803. Other definitions and rules.
Sec. 804. Reserve and other policy liability deduction.
Sec. 805. 1954 life insurance company taxable income.
Sec. 806. Adjustment for certain reserves.
Sec. 807. Foreign life insurance companies.

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if its life insurance reserves (as defined in section 803 (b)), plus unearned premiums and unpaid losses on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves. For purposes of this section, the term "total reserves" means life insurance reserves, unearned premiums and unpaid losses not included in life insurance reserves, and all other insurance reserves required by law. A burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under section 802 but shall be taxable under section 821 or section 831.

SEC. 802. IMPOSITION OF TAX.

(a) IN GENERAL.—Except as otherwise provided in subsection (b), there shall be imposed for each taxable year on the life insurance company taxable income of every life insurance company a tax consisting of a normal tax and a surtax computed as provided in section 11. For purposes of such tax, the term "life insurance company taxable income" means the taxable income (as defined in section 803 (g)) minus the reserve and other policy liability deduction provided in section 804 and plus the amount of the adjustment for certain reserves provided in section 806. For purposes of the surtax, such taxable income shall be computed without regard to the deduction provided in section 242 for partially tax-exempt interest.

(b) TAXABLE YEARS BEGINNING IN 1954.—In lieu of the tax imposed by subsection (a) there shall be imposed, for taxable years beginning in 1954, on the 1954 life insurance company taxable income

(as defined in section 805) of every life insurance company a tax equal to the sum of the following:

(1) 3¾ percent of the amount thereof not in excess of $200,000, plus

(2) 6½ percent of the amount thereof in excess of $200,000.

SEC. 803. OTHER DEFINITIONS AND RULES.

(a) APPLICATION OF SECTION; GROSS INCOME.—

(1) APPLICATION.—The definitions and rules contained in this section shall apply only in the case of life insurance companies.

(2) GROSS INCOME.—The term "gross income" means the gross amount of income received or accrued during the taxable year from interest, dividends, and rents.

(b) LIFE INSURANCE RESERVES.—The term "life insurance reserves" means amounts which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Such life insurance reserves, except in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation and except as hereinafter provided in the case of assessment life insurance, must also be required by law. In the case of an assessment life insurance company or association, the term "life insurance reserves" includes sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained, under the charter or articles of incorporation or association (or bylaws approved by a State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

(c) ADJUSTED RESERVES.—The term "adjusted reserves" means life insurance reserves plus 7 percent of that portion of such reserves as are computed on a preliminary term basis.

(d) RESERVE EARNINGS RATE.—The term "reserve earnings rate" means a rate computed by adding 2.1125 percent (65 percent of 3¼ percent) to 35 percent of the average rate of interest assumed in computing life insurance reserves. Such average rate shall be calculated by multiplying each assumed rate of interest by the means of the amounts of the adjusted reserves computed at that rate at the beginning and end of the taxable year and dividing the sum of the products by the mean of the total adjusted reserves at the beginning and end of the taxable year.

(e) RESERVE FOR DEFERRED DIVIDENDS.—The term "reserve for deferred dividends" means sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the

year following the taxable year) the payment of which is deferred for a period of not less than 5 years from the date of the policy contract.

(f) INTEREST PAID.—The term "interest paid" means—

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

(2) All amounts in the nature of interest, whether or not guaranteed, paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve, at the time of payment or accrual, life, health, or accident contingencies.

(g) TAXABLE INCOME.—The term "taxable income" means the gross income less the following deductions:

(1) TAX-FREE INTEREST.—The amount of interest received or accrued during the taxable year which under section 103 is excluded from gross income.

(2) INVESTMENT EXPENSES.—Investment expenses paid or incurred during the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year plus one-fourth of the amount by which taxable income (computed without any deduction for investment expenses allowed by this paragraph, for tax-free interest allowed by paragraph (1), or for partially tax-exempt interest and dividends received allowed by paragraph (5)) exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

(3) REAL ESTATE EXPENSES.—Taxes and other expenses paid or accrued during the taxable year exclusively on or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed on a shareholder of a company on his interest as shareholder, which are paid or accrued by the company without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

(4) DEPRECIATION.—The depreciation deduction allowed by section 167.

(5) SPECIAL DEDUCTIONS.—The special deductions allowed by part VIII of subchapter B (except section 248).

(h) RENTAL VALUE OF REAL ESTATE.—The deduction under subsection (g) (3) and (4) on account of any real estate owned and occupied in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this subsection) as the rental value of the space not so occupied bears to the rental value of the entire property.

(i) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—The gross income, the deduction provided in subsection (g) (1), and the deduction allowed by section 242 (relating to partially tax-exempt interest) shall each be decreased to reflect the appropriate amortization of premium and increased to reflect the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined—

(1) in accordance with the method regularly employed by such company, if such method is reasonable, and

(2) in all other cases, in accordance with regulations prescribed by the Secretary or his delegate.

(j) DOUBLE DEDUCTIONS.—Nothing in this part shall permit the same item to be deducted more than once.

SEC. 804. RESERVE AND OTHER POLICY LIABILITY DEDUCTION.

(a) IN GENERAL.—For purposes of this subpart, the term "reserve and other policy liability deduction" means an amount computed by multiplying the taxable income by a figure, to be determined and proclaimed by the Secretary or his delegate for each taxable year. This figure shall be based on such data with respect to life insurance companies for the preceding taxable year as the Secretary or his delegate considers representative and shall be computed in accordance with the following formula: The ratio which a numerator comprised of the aggregate of the sums of—

(1) 2 percent of the reserves for deferred dividends,

(2) interest paid, and

(3) the product of—

(A) the mean of the adjusted reserves at the beginning and end of the taxable year and

(B) the reserve earnings rate,

bears to a denominator comprised of the aggregate of the excess of taxable incomes (computed without any deduction for tax-free interest, partially tax-exempt interest, or dividends received) over the adjustment for certain reserves provided in section 806.

(b) SURTAX COMPUTATION.—In determining the life insurance company taxable income for purposes of the surtax, the taxable income to be multiplied by the figure determined and proclaimed under subsection (a) shall be computed without regard to the deduction provided in section 242 for partially tax-exempt interest.

SEC. 805. 1954 LIFE INSURANCE COMPANY TAXABLE INCOME.

(a) DEFINITION.—For purposes of section 802 (b), the term "1954 life insurance company taxable income" means the taxable income (as defined in section 803 (g)), plus 8 times the amount of the adjustment for certain reserves provided in section 806, and minus the reserve interest credit, if any, provided in subsection (b) of this section.

(b) RESERVE INTEREST CREDIT.—For purposes of subsection (a), the reserve interest credit shall be an amount determined as follows:

(1) Divide the amount of the adjusted taxable income (as defined in subsection (c)) by the amount of the required interest (as defined in subsection (d)).

(2) If the quotient obtained in paragraph (1) is 1.05 or more, the reserve interest credit shall be zero.

(3) If the quotient obtained in paragraph (1) is 1.00 or less, the reserve interest credit shall be an amount equal to 50 percent of the taxable income.

(4) If the quotient obtained in paragraph (1) is more than 1.00 but less than 1.05, the reserve interest credit shall be the amount obtained by multiplying the taxable income by 10 times the difference between the figures 1.05 and such quotient.

(c) ADJUSTED TAXABLE INCOME.—For purposes of subsection (b) (1), the term "adjusted taxable income" means the taxable income (computed without the deductions provided in section 803 (g) (1) or (5)) minus 50 percent of the amount of the adjustment for certain reserves provided in section 806.

(d) REQUIRED INTEREST.—For purposes of subsection (b) (1), the term "required interest" means the total of—

(1) the sum of the amounts obtained by multiplying—

(A) each rate of interest assumed in computing the taxpayer's life insurance reserves by

(B) the means of the amounts of the taxpayer's adjusted reserves computed at that rate at the beginning and end of the taxable year,

(2) 2 percent of the reserve for deferred dividends, and

(3) interest paid.

SEC. 806. ADJUSTMENT FOR CERTAIN RESERVES.

In the case of a life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance), the term "adjustment for certain reserves" means an amount equal to 3¼ percent of the unearned premiums and unpaid losses on such other contracts which are not included in life insurance reserves (as defined in section 803 (b). For purposes of this section, such unearned premiums shall not be considered to be less than 25 percent of the net premiums written during the taxable year on such other contracts.

SEC. 807. FOREIGN LIFE INSURANCE COMPANIES.

(a) CARRYING ON UNITED STATES INSURANCE BUSINESS.—A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable in the same manner as a domestic life insurance company; except that the determinations necessary for purposes of this subtitle shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Insurance Commissioners.

(b) NO UNITED STATES INSURANCE BUSINESS.—Foreign life insurance companies not carrying on an insurance business within the United States shall not be taxable under this section but shall be taxable as other foreign corporations.

PART II—MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE OR MARINE OR FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES)

Sec. 821. Tax on mutual insurance companies (other than life or marine or fire insurance companies issuing perpetual policies).
Sec. 822. Determination of mutual insurance company taxable income.
Sec. 823. Other definitions.

SEC. 821. TAX ON MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE OR MARINE OR FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES).

(a) IMPOSITION OF TAX ON MUTUAL COMPANIES OTHER THAN INTERINSURERS.—There shall be imposed for each taxable year on the income of every mutual insurance company (other than a life or a marine insurance company or a fire insurance company subject to the tax imposed by section 831 and other than an interinsurer or reciprocal underwriter) a tax computed under paragraph (1) or paragraph (2), whichever is the greater:

(1) If the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) is over $3,000, a tax computed as follows:

(A) NORMAL TAX.—

(i) TAXABLE YEARS BEGINNING BEFORE APRIL 1, 1955.—In the case of taxable years beginning before April 1, 1955, a normal tax of 30 percent of the mutual insurance company taxable income, or 60 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser;

(ii) TAXABLE YEARS BEGINNING AFTER MARCH 31, 1955.—In the case of taxable years beginning after March 31, 1955, a normal tax of 25 percent of the mutual insurance company taxable income, or 50 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser; plus

(B) SURTAX.—A surtax of 22 percent of the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000.

(2) If for the taxable year the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus the interest which under section 103 is excluded from gross income, exceeds $75,000, a tax equal to 1 percent of the amount so computed, or 2 percent of the excess of the amount so computed over $75,000, whichever is the lesser.

(b) IMPOSITION OF TAX ON INTERINSURERS.—In the case of every mutual insurance company which is an interinsurer or reciprocal underwriter (other than a life or a marine insurance company or a fire insurance company subject to the tax imposed by section 831), if the mutual insurance company taxable income (computed as provided in subsection (a) (1)) is over $50,000, there shall be imposed for each taxable year on the mutual insurance company taxable income a tax computed as follows:

(1) NORMAL TAX.—

(A) TAXABLE YEARS BEGINNING BEFORE APRIL 1, 1955.—In the case of taxable years beginning before April 1, 1955, a normal tax of 30 percent of the mutual insurance company taxable income, or 60 percent of the amount by which such taxable income exceeds $50,000, whichever is the lesser;

(B) TAXABLE YEARS BEGINNING AFTER MARCH 31, 1955.—In the case of a taxable year beginning after March 31, 1955, a normal tax of 25 percent of the mutual insurance company taxable income, or 50 percent of the amount by which such taxable income exceeds $50,000, whichever is the lesser; plus

(2) SURTAX.—A surtax of 22 percent of the mutual insurance company taxable income (computed as provided in subsection (a)(1)) in excess of $25,000, or 33 percent of the amount by which such taxable income exceeds $50,000, whichever is the lesser.

(c) GROSS AMOUNT RECEIVED, OVER $75,000 BUT LESS THAN $125,000.—If the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 but less than $125,000, the tax imposed by subsection (a) or subsection (b), whichever applies, shall be reduced to an amount which bears the same proportion to the amount of the tax determined under such subsection as the excess over $75,000 of such gross amount received bears to $50,000.

(d) NO UNITED STATES INSURANCE BUSINESS.—Foreign mutual insurance companies (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States shall not be subject to this part but shall be taxable as other foreign corporations.

(e) ALTERNATIVE TAX ON CAPITAL GAINS.—

For alternative tax in case of capital gains, see section 1201 (a).

SEC. 822. DETERMINATION OF MUTUAL INSURANCE COMPANY TAXABLE INCOME.

(a) DEFINITION.—For purposes of section 821, the term "mutual insurance company taxable income" means the gross investment income minus the deductions provided in subsection (c).

(b) GROSS INVESTMENT INCOME.—For purposes of subsection (a), the term "gross investment income" means the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets to the extent provided in subchapter P (sec. 1201 and following, relating to capital gains and losses).

(c) DEDUCTIONS.—In computing mutual insurance company taxable income, the following deductions shall be allowed:

(1) TAX-FREE INTEREST.—The amount of interest which under section 103 is excluded for the taxable year from gross income.

(2) INVESTMENT EXPENSES.—Investment expenses paid or accrued during the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year plus one-fourth of the

amount by which mutual insurance company taxable income (computed without any deduction for investment expenses allowed by this paragraph, for tax-free interest allowed by paragraph (1), or for partially tax-exempt interest and dividends received allowed by paragraph (7)), exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

(3) REAL ESTATE EXPENSES.—Taxes and other expenses paid or accrued during the taxable year exclusively on or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed on a shareholder of a company on his interest as shareholder, which are paid or accrued by the company without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

(4) DEPRECIATION.—The depreciation deduction allowed by section 167.

(5) INTEREST PAID OR ACCRUED.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest on which is wholly exempt from taxation under this subtitle.

(6) CAPITAL LOSSES.—Capital losses to the extent provided in subchapter P (sec. 1201 and following) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Capital assets shall be considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders to the extent that the gross receipts from their sale or exchange are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, losses paid, and expenses paid over the sum of interest, dividends, rents, and net premiums received. In the application of section 1211 for purposes of this section, the net capital loss for the taxable year shall be the amount by which losses for such year from sales or exchanges of capital assets exceeds the sum of the gains from such sales or exchanges and whichever of the following amounts is the lesser:

(A) the mutual insurance company taxable income (computed without regard to gains or losses from sales or exchanges of capital assets or to the deduction provided in section 242 for partially tax-exempt interest); or

(B) losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses

and to provide for the payment of dividends and similar distributions to policyholders.

(7) SPECIAL DEDUCTIONS.—The special deductions allowed by part VIII (except section 248) of subchapter B (sec. 241 and following, relating to partially tax-exempt interest and to dividends received).

(d) OTHER APPLICABLE RULES.—

(1) RENTAL VALUE OF REAL ESTATE.—The deduction under subsection (e) (3) or (4) on account of any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this paragraph) as the rental value of the space not so occupied bears to the rental value of the entire property.

(2) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—The gross amount of income during the taxable year from interest, the deduction provided in subsection (c) (1), and the deduction allowed by section 242 (relating to partially tax-exempt interest) shall each be decreased to reflect the appropriate amortization of premium and increased to reflect the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual shall be determined—

(A) in accordance with the method regularly employed by such company, if such method is reasonable, and

(B) in all other cases, in accordance with regulations prescribed by the Secretary or his delegate.

(3) DOUBLE DEDUCTIONS.—Nothing in this part shall permit the same item to be deducted more than once.

(e) FOREIGN MUTUAL INSURANCE COMPANIES OTHER THAN LIFE OR MARINE.—In the case of a foreign mutual insurance company (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 831), the mutual insurance company taxable income shall be the taxable income from sources within the United States (computed without regard to the deductions allowed by subsection (c) (7)), and the gross amount of income from the interest, dividends, rents, and net premiums shall be the amount of such income from sources within the United States. In the case of a company to which the preceding sentence applies, the deductions allowed in this section shall be allowed to the extent provided in subpart B of part II of subchapter N (sec. 881 and following) in the case of a foreign corporation engaged in trade or business within the United States.

SEC. 823. OTHER DEFINITIONS.

For purposes of this part—

(1) NET PREMIUMS.—The term "net premiums" means gross premiums (including deposits and assessments) written or received on insurance contracts during the taxable year less return premiums and premiums paid or incurred for reinsurance. Amounts returned where the amount is not fixed in the insurance contract but depends on the experience of the company or the discretion

of the management shall not be included in return premiums but shall be treated as dividends to policyholders under paragraph (2).

(2) DIVIDENDS TO POLICYHOLDERS.—The term "dividends to policyholders" means dividends and similar distributions paid or declared to policyholders. For purposes of the preceding sentence, the term "paid or declared" shall be construed according to the method regularly employed in keeping the books of the insurance company.

PART III—OTHER INSURANCE COMPANIES

Sec. 831. Tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies.
Sec. 832. Insurance company taxable income.

SEC. 831. TAX ON INSURANCE COMPANIES (OTHER THAN LIFE OR MUTUAL), MUTUAL MARINE INSURANCE COMPANIES, AND MUTUAL FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES.

(a) IMPOSITION OF TAX.—Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company (other than a life or mutual insurance company), every mutual marine insurance company, and every mutual fire insurance company exclusively issuing either perpetual policies or policies for which the sole premium charged is a single deposit which (except for such deduction of underwriting costs as may be provided) is refundable on cancellation or expiration of the policy.

(b) NO UNITED STATES INSURANCE BUSINESS.—Foreign insurance companies (other than a life or mutual insurance company), foreign mutual marine insurance companies, and foreign mutual fire insurance companies described in subsection (a), not carrying on an insurance business within the United States, shall not be subject to this part but shall be taxable as other foreign corporations.

(c) ALTERNATIVE TAX ON CAPITAL GAINS.—

For alternative tax in case of capital gains, see section 1201 (a).

SEC. 832. INSURANCE COMPANY TAXABLE INCOME.

(a) DEFINITION OF TAXABLE INCOME.—In the case of an insurance company subject to the tax imposed by section 831, the term "taxable income" means the gross income as defined in subsection (b) (1) less the deductions allowed by subsection (c).

(b) DEFINITIONS.—In the case of an insurance company subject to the tax imposed by section 831—

(1) GROSS INCOME.—The term "gross income" means the sum of—

(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners,

(B) gain during the taxable year from the sale or other disposition of property, and

(C) all other items constituting gross income under subchapter B, except that, in the case of a mutual fire insurance company

described in section 831 (a), the amount of single deposit premiums paid to such company shall not be included in gross income.

(2) INVESTMENT INCOME.—The term "investment income" means the gross amount of income earned during the taxable year from interest, dividends, and rents, computed as follows: To all interest, dividends, and rents received during the taxable year, add interest, dividends, and rents due and accrued at the end of the taxable year, and deduct all interest, dividends, and rents due and accrued at the end of the preceding taxable year.

(3) UNDERWRITING INCOME.—The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

(4) PREMIUMS EARNED.—The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

(A) From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance.

(B) To the result so obtained, add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year.

For purposes of this subsection, unearned premiums shall include life insurance reserves, as defined in section 806, pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801.

(5) LOSSES INCURRED.—The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

(A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.

(B) To the result so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

(6) EXPENSES INCURRED.—The term "expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows: To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).

(c) DEDUCTIONS ALLOWED.—In computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:

(1) all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses);

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(2) all interest, as provided in section 163;

(3) taxes, as provided in section 164;

(4) losses incurred, as defined in subsection (b) (5) of this section;

(5) capital losses to the extent provided in subchapter P (sec. 1201 and following, relating to capital gains and losses) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Capital assets shall be considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders to the extent that the gross receipts from their sale or exchange are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders in their capacity as such, losses paid, and expenses paid over the sum of interest, dividends, rents, and net premiums received. In the application of section 1211 for purposes of this section, the net capital loss for the taxable year shall be the amount by which losses for such year from sales or exchanges of capital assets exceeds the sum of the gains from such sales or exchanges and whichever of the following amounts is the lesser:

(A) the taxable income (computed without regard to gains or losses from sales or exchanges of capital assets or to the deductions provided in section 242 for partially tax-exempt interest); or

(B) losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders;

(6) debts in the nature of agency balances and bills receivable which become worthless within the taxable year;

(7) the amount of interest earned during the taxable year which under section 103 is excluded from gross income;

(8) the depreciation deduction allowed by section 167;

(9) charitable, etc., contributions, as provided in section 170;

(10) deductions (other than those specified in this subsection) as provided in part VI of subchapter B (sec. 161 and following, relating to itemized deductions for individuals and corporations);

(11) dividends and similar distributions paid or declared to policyholders in their capacity as such, except in the case of a mutual fire insurance company described in section 831 (a). For purposes of the preceding sentence, the term "paid or declared" shall be construed according to the method of accounting regularly employed in keeping the books of the insurance company; and

(12) the special deductions allowed by part VIII of subchapter B (sec. 241 and following, relating to partially tax-exempt interest and to dividends received).

(d) TAXABLE INCOME OF FOREIGN INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL AND FOREIGN MUTUAL MARINE.—In the case of a foreign insurance company (other than a life or mutual insurance company), a foreign mutual marine insurance company, and a foreign

mutual fire insurance company described in section 831 (a), the taxable income shall be the taxable income from sources within the United States. In the case of a company to which the preceding sentence applies, the deductions allowed in this section shall be allowed to the extent provided in subpart B of part II of subchapter N (sec. 881 and following) in the case of a foreign corporation engaged in trade or business within the United States.

(e) DOUBLE DEDUCTIONS.—Nothing in this section shall permit the same item to be deducted more than once.

PART IV—PROVISIONS OF GENERAL APPLICATION

Sec. 841. Credit for foreign taxes.
Sec. 842. Computation of gross income.

SEC. 841. CREDIT FOR FOREIGN TAXES.

The taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 802, 821, or 831, to the extent provided in the case of a domestic corporation in section 901 (relating to foreign tax credit). For purposes of the preceding sentence, the term "taxable income" as used in section 904 means—

(1) in the case of the tax imposed by section 802, the taxable income (as defined in section 803 (g)),

(2) in the case of the tax imposed by section 831, the taxable income (as defined in section 832 (a)).

SEC. 842. COMPUTATION OF GROSS INCOME.

The gross income of insurance companies subject to the tax imposed by section 802 or 831 shall not be determined in the manner provided in part I of subchapter N (relating to determination of sources of income).

Subchapter M—Regulated Investment Companies

Sec. 851. Definition of regulated investment company.
Sec. 852. Taxation of regulated investment companies and their shareholders.
Sec. 853. Foreign tax credit allowed to shareholders.
Sec. 854. Limitations applicable to dividends received from regulated investment company.
Sec. 855. Dividends paid by regulated investment company after close of taxable year.

SEC. 851. DEFINITION OF REGULATED INVESTMENT COMPANY.

(a) GENERAL RULE.—For purposes of this subtitle, the term "regulated investment company" means any domestic corporation (other than a personal holding company as defined in section 542)—

(1) which, at all times during the taxable year, is registered under the Investment Company Act of 1940, as amended (54 Stat. 789; 15 U. S. C. 80 a–1 to 80 b–2), either as a management company or as a unit investment trust, or

(2) which is a common trust fund or similar fund excluded by section 3 (c) (3) of such Act (15 U. S. C. 80 a–3 (c)) from the definition of "investment company" and is not included in the definition of "common trust fund" by section 584 (a).

(b) LIMITATIONS.—A corporation shall not be considered a regulated investment company for any taxable year unless—

(1) it files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year which began after December 31, 1941;

(2) at least 90 percent of its gross income is derived from dividends, interest, and gains from the sale or other disposition of stock or securities;

(3) less than 30 percent of its gross income is derived from the sale or other disposition of stock or securities held for less than 3 months; and

(4) at the close of each quarter of the taxable year—

(A) at least 50 percent of the value of its total assets is represented by—

(i) cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and

(ii) other securities for purposes of this calculation limited, except and to the extent provided in subsection (e), in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and

(B) not more than 25 percent of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer controls and

which are determined, under regulations prescribed by the Secretary or his delegate, to be engaged in the same or similar trades or businesses or related trades or businesses.

(c) RULES APPLICABLE TO SUBSECTION (b) (4).—For purposes of subsection (b) (4) and this subsection—

(1) In ascertaining the value of the taxpayer's investment in the securities of an issuer, for the purposes of subparagraph (B), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer, as determined under regulations prescribed by the Secretary or his delegate.

(2) The term "controls" means the ownership in a corporation of 20 percent or more of the total combined voting power of all classes of stock entitled to vote.

(3) The term "controlled group" means one or more chains of corporations connected through stock ownership with the taxpayer if—

(A) 20 percent or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and

(B) the taxpayer owns directly 20 percent or more of the total combined voting power of all classes of stock entitled to vote, of at least one of the other corporations.

(4) The term "value" means, with respect to securities (other than those of majority-owned subsidiaries) for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the board of directors, except that in the case of securities of majority-owned subsidiaries which are investment companies such fair value shall not exceed market value or asset value, whichever is higher.

(5) All other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended.

(d) DETERMINATION OF STATUS.—A corporation which meets the requirements of subsections (b) (4) and (c) at the close of any quarter shall not lose its status as a regulated investment company because of a discrepancy during a subsequent quarter between the value of its various investments and such requirements unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. A corporation which does not meet such requirements at the close of any quarter by reason of a discrepancy existing immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter shall not lose its status for such quarter as a regulated investment company if such discrepancy is eliminated within 30 days after the close of such quarter and in such cases it shall be considered to have met such requirements at the close of such quarter for purposes of applying the preceding sentence.

(e) INVESTMENT COMPANIES FURNISHING CAPITAL TO DEVELOPMENT CORPORATIONS.—

(1) GENERAL RULE.—If the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate not less than 60 days prior to the close of the taxable year of a registered management company, that such investment company is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, such investment company may, in the computation of 50 percent of the value of its assets under subparagraph (A) of subsection (b) (4) for any quarter of such taxable year, include the value of any securities of an issuer, whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer, the basis of which, when added to the basis of the investment company for securities of such issuer previously acquired, did not exceed 5 percent of the value of the total assets of the investment company at the time of the subsequent acquisition of securities. The preceding sentence shall not apply to the securities of an issuer if the investment company has continuously held any security of such issuer (or of any predecessor company of such issuer as determined under regulations prescribed by the Secretary or his delegate) for 10 or more years preceding such quarter of such taxable year.

(2) LIMITATION.—The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issues and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(3) DETERMINATION OF STATUS.—For purposes of this subsection, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years prior to such date it has acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or predecessor thereof. For purposes of the certification under this subsection, the Securities and Exchange Commission shall have authority to issue such rules, regulations and orders, and to

conduct such investigations and hearings, either public or private, as it may deem appropriate.

(4) DEFINITIONS.—The terms used in this subsection shall have the same meaning as in subsections (b) (4) and (c) of this section.

SEC. 852. TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS.

(a) REQUIREMENTS APPLICABLE TO REGULATED INVESTMENT COMPANIES.—The provisions of this subchapter shall not be applicable to a regulated investment company for a taxable year unless—

(1) the deduction for dividends paid during the taxable year (as defined in section 561, but without regard to capital gains dividends) equals or exceeds 90 percent of its investment company taxable income for the taxable year (determined without regard to subsection (b) (2) (D)), and

(2) the investment company complies for such year with regulations prescribed by the Secretary or his delegate for the purpose of ascertaining the actual ownership of its outstanding stock.

(b) METHOD OF TAXATION OF COMPANIES AND SHAREHOLDERS.—

(1) IMPOSITION OF NORMAL TAX AND SURTAX ON REGULATED INVESTMENT COMPANIES.—There is hereby imposed for each taxable year upon the investment company taxable income of every regulated investment company a normal tax and surtax computed as provided in section 11, as though the investment company taxable income were the taxable income referred to in section 11. For purposes of computing the normal tax under section 11, the taxable income and the dividends paid deduction of such investment company for the taxable year (computed without regard to capital gains dividends) shall be reduced by the deduction provided by section 242 (relating to partially tax-exempt interest).

(2) INVESTMENT COMPANY TAXABLE INCOME.—The investment company taxable income shall be the taxable income of the regulated investment company adjusted as follows:

(A) There shall be excluded the excess, if any, of the net long-term capital gain over the net short-term capital loss.

(B) The net operating loss deduction provided in section 172 shall not be allowed.

(C) The deductions for corporations provided in part VIII (except section 248) in subchapter B (section 241 and following, relating to the deduction for dividends received, etc.) shall not be allowed.

(D) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gains dividends.

(E) The taxable income shall be computed without regard to section 443 (b) (relating to computation of tax on change of annual accounting period).

(3) CAPITAL GAINS.—

(A) IMPOSITION OF TAX.—There is hereby imposed for each taxable year in the case of every regulated investment company a tax of 25 percent of the excess, if any, of the net long-term capital gain over the sum of—

(i) the net short-term capital loss, and

(ii) the deduction for dividends paid (as defined in section 561) determined with reference to capital gains dividends only.

(B) TREATMENT OF CAPITAL GAIN DIVIDENDS BY SHAREHOLDERS.—A capital gain dividend shall be treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than 6 months.

(C) DEFINITION OF CAPITAL GAIN DIVIDEND.—A capital gain dividend means any dividend, or part thereof, which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including capital gains dividends paid after the close of the taxable year described in section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated.

(c) EARNINGS AND PROFITS.—The earnings and profits of a regulated investment company for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year.

SEC. 853. FOREIGN TAX CREDIT ALLOWED TO SHAREHOLDERS.

(a) GENERAL RULE.—A regulated investment company—

(1) more than 50 percent of the value (as defined in section 851 (c) (4)) of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations, and

(2) which meets the requirements of section 852 (a) for the taxable year,

may, for such taxable year, elect the application of this section with respect to income, war profits, and excess profits taxes described in section 901 (b) (1), which are paid by the investment company during such taxable year to foreign countries and possessions of the United States.

(b) EFFECT OF ELECTION.—If the election provided in subsection (a) is effective for a taxable year—

(1) the regulated investment company—

(A) shall not, with respect to such taxable year, be allowed a deduction under section 164 (a) or a credit under section 901 for taxes to which subsection (a) is applicable, and

(B) shall be allowed as an addition to the dividends paid deduction for such taxable year the amount of such taxes;

(2) each shareholder of such investment company shall—

(A) include in gross income and treat as paid by him his proportionate share of such taxes, and

(B) treat as gross income from sources within the respective foreign countries and possessions of the United States, for purposes of applying subpart A of part III of subchapter N, the sum of his proportionate share of such taxes and the portion of any dividend paid by such investment company which repre-

sents income derived from sources within foreign countries or possessions of the United States.

(c) NOTICE TO SHAREHOLDERS.—The amounts to be treated by the shareholder, for purposes of subsection (b) (2), as his proportionate share of—

(1) taxes paid to any foreign country or possession of the United States, and

(2) gross income derived from sources within any foreign country or possession of the United States,

shall not exceed the amounts so designated by the company in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year.

(d) MANNER OF MAKING ELECTION AND NOTIFYING SHAREHOLDERS.—The election provided in subsection (a) and the notice to shareholders required by subsection (c) shall be made in such manner as the Secretary or his delegate may prescribe by regulations.

(e) CROSS REFERENCES.—

(1) For treatment by shareholders of taxes paid to foreign countries and possessions of the United States, see section 164 (a) and section 901.

(2) For definition of foreign corporation, see section 7701 (a) (5).

SEC. 854. LIMITATIONS APPLICABLE TO DIVIDENDS RECEIVED FROM REGULATED INVESTMENT COMPANY.

(a) CAPITAL GAIN DIVIDEND.—For purposes of section 34 (a) (relating to credit for dividends received by individuals), section 116 (relating to an exclusion for dividends received by individuals), and section 243 (relating to deductions for dividends received by corporations), a capital gain dividend (as defined in section 852 (b) (3)) received from a regulated investment company shall not be considered as a dividend.

(b) OTHER DIVIDENDS.—

(1) GENERAL RULE.—In the case of a dividend received from a regulated investment company (other than a dividend to which subsection (a) applies)—

(A) if such investment company meets the requirements of section 852 (a) for the taxable year during which it paid such dividend; and

(B) the aggregate dividends received by such company during such taxable year are less than 75 percent of its gross income,

then, in computing the credit under section 34 (a), the exclusion under section 116, and the deduction under section 243, there shall be taken into account only that portion of the dividend which bears the same ratio to the amount of such dividend as the aggregate dividends received by such company during such taxable year bear to its gross income for such taxable year.

(2) NOTICE TO SHAREHOLDERS.—The amount of any distribution by a regulated investment company which may be taken into account as a dividend for purposes of the credit under section 34, the exclusion under section 116, and the deduction under section 243 shall not exceed the amount so designated by the company in a written notice to its shareholders mailed not later than 30 days after the close of its taxable year.

(3) DEFINITIONS.—For purposes of this subsection—

(A) The term "gross income" does not include gain from the sale or other disposition of stock or securities.

(B) The term "aggregate dividends received" includes only dividends received from domestic corporations other than dividends described in section 116 (b) (relating to dividends excluded from gross income). In determining the amount of any dividend for purposes of this subparagraph, the rules provided in section 116 (c) (relating to certain distributions) shall apply.

SEC. 855. DIVIDENDS PAID BY REGULATED INVESTMENT COMPANY AFTER CLOSE OF TAXABLE YEAR.

(a) GENERAL RULE.—For purposes of this chapter, if a regulated investment company—

(1) declares a dividend prior to 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

(2) distributes the amount of such dividend to shareholders 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 company elects in such return in accordance with regulations prescribed by the Secretary or his delegate, be considered as having been paid during such taxable year, except as provided in subsections (b), (c) and (d).

(b) RECEIPT BY SHAREHOLDER.—Amounts to which subsection (a) is applicable shall be treated as received by the shareholder in the taxable year in which the distribution is made.

(c) NOTICE TO SHAREHOLDERS.—In the case of amounts to which subsection (a) is applicable, any notice to shareholders required under this subchapter with respect to such amounts shall be made not later than 30 days after the close of the taxable year in which the distribution is made.

(d) FOREIGN TAX ELECTION.—If an investment company to which section 853 is applicable for the taxable year makes a distribution as provided in subsection (a) of this section, the shareholders shall consider the amounts described in section 853 (b) (2) allocable to such distribution as paid or received, as the case may be, in the taxable year in which the distribution is made.

Subchapter N—Tax Based on Income From Sources Within or Without the United States

Part I. Determination of sources of income.
Part II. Nonresident aliens and foreign corporations.
Part III. Income from sources without the United States.

PART I—DETERMINATION OF SOURCES OF INCOME

Sec. 861. Income from sources within the United States.
Sec. 862. Income from sources without the United States.
Sec. 863. Items not specified in section 861 or 862.
Sec. 864. Definitions.

SEC. 861. INCOME FROM SOURCES WITHIN THE UNITED STATES.

(a) GROSS INCOME FROM SOURCES WITHIN UNITED STATES.—The following items of gross income shall be treated as income from sources within the United States:

(1) INTEREST.—Interest from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including—

(A) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States,

(B) interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Secretary or his delegate that less than 20 percent of the gross income of such resident payor or domestic corporation has been derived from sources within the United States, as determined under the provisions of this part, for the 3-year period ending with the close of the taxable year of such payor preceding the payment of such interest, or for such part of such period as may be applicable, and

(C) income derived by a foreign central bank of issue from bankers' acceptances.

(2) DIVIDENDS.—The amount received as dividends—

(A) from a domestic corporation other than a corporation entitled to the benefits of section 931, and other than a corporation less than 20 percent of whose gross income is shown to the satisfaction of the Secretary or his delegate to have been derived from sources within the United States, as determined under the provisions of this part, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence), or

(B) from a foreign corporation unless less than 50 percent of the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources

within the United States as determined under the provisions of this part; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources; but dividends from a foreign corporation shall, for purposes of subpart A of part III (relating to foreign tax credit), be treated as income from sources without the United States to the extent exceeding the amount of the deduction allowable under section 245 in respect of such dividends.

(3) PERSONAL SERVICES.—Compensation for labor or personal services performed in the United States; except that compensation for labor or services performed in the United States shall not be deemed to be income from sources within the United States if—

(A) the labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year,

(B) such compensation does not exceed $3,000 in the aggregate, and

(C) the compensation is for labor or services performed as an employee of or under a contract with—

(i) a nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(ii) a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such corporation.

(4) RENTALS AND ROYALTIES.—Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property.

(5) SALE OF REAL PROPERTY.—Gains, profits, and income from the sale of real property located in the United States.

(6) SALE OF PERSONAL PROPERTY.—Gains, profits, and income derived from the purchase of personal property without the United States (other than within a possession of the United States) and its sale within the United States.

(b) TAXABLE INCOME FROM SOURCES WITHIN UNITED STATES.—From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

SEC. 862. INCOME FROM SOURCES WITHOUT THE UNITED STATES.

(a) GROSS INCOME FROM SOURCES WITHOUT UNITED STATES.—The following items of gross income shall be treated as income from sources without the United States:

(1) interest other than that derived from sources within the United States as provided in section 861 (a) (1);

(2) dividends other than those derived from sources within the United States as provided in section 861 (a) (2);

(3) compensation for labor or personal services performed without the United States;

(4) rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties;

(5) gains, profits, and income from the sale of real property located without the United States; and

(6) gains, profits, and income derived from the purchase of personal property within the United States and its sale without the United States.

(b) TAXABLE INCOME FROM SOURCES WITHOUT UNITED STATES.—From the items of gross income specified in subsection (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as taxable income from sources without the United States.

SEC. 863. ITEMS NOT SPECIFIED IN SECTION 861 OR 862.

(a) ALLOCATION UNDER REGULATIONS.—Items of gross income, expenses, losses, and deductions, other than those specified in sections 861 (a) and 862 (a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary or his delegate. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the taxable income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

(b) INCOME PARTLY FROM WITHIN AND PARTLY FROM WITHOUT THE UNITED STATES.—In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary or his delegate. Gains, profits, and income—

(1) from transportation or other services rendered partly within and partly without the United States,

(2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, or

(3) derived from the purchase of personal property within a possession of the United States and its sale within the United States,

shall be treated as derived partly from sources within and partly from sources without the United States.

SEC. 864. DEFINITIONS.

For purposes of this part, the word "sale" includes "exchange"; the word "sold" includes "exchanged"; and the word "produced" includes "created", "fabricated", "manufactured", "extracted", "processed", "cured", or "aged".

PART II—NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

Subpart A. Nonresident alien individuals.
Subpart B. Foreign corporations.
Subpart C. Miscellaneous provisions.

Subpart A—Nonresident Alien Individuals

Sec. 871. Tax on nonresident alien individuals.
Sec. 872. Gross income.
Sec. 873. Deductions.
Sec. 874. Allowance of deductions and credits.
Sec. 875. Partnerships.
Sec. 876. Alien residents of Puerto Rico.
Sec. 877. Foreign educational, charitable, and certain other exempt organizations.

SEC. 871. TAX ON NONRESIDENT ALIEN INDIVIDUALS.

(a) NO UNITED STATES BUSINESS AND GROSS INCOME OF NOT MORE THAN $15,400.—

(1) IMPOSITION OF TAX.—Except as otherwise provided in subsection (b) there is hereby imposed for each taxable year, in lieu of the tax imposed by section 1, on the amount received, by every nonresident alien individual not engaged in trade or business within the United States, from sources within the United States, as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (including amounts described in section 402 (a) (2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets), a tax of 30 percent of such amount.

(2) CAPITAL GAINS OF ALIENS TEMPORARILY PRESENT IN THE UNITED STATES.—In the case of a nonresident alien individual not engaged in trade or business in the United States, there is hereby imposed for each taxable year, in addition to the tax imposed by paragraph (1)—

(A) if he is present in the United States for a period or periods aggregating less than 90 days during such taxable year—a tax of 30 percent of the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected during his presence in the United States

exceed his losses, allocable to sources within the United States, from such sales or exchanges effected during such presence; or

(B) if he is present in the United States for a period or periods aggregating 90 days or more during such taxable year—a tax of 30 percent of the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during such year exceed his losses, allocable to sources within the United States, from such sales or exchanges effected at any time during such year.

For purposes of this paragraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if such individual were engaged in trade or business in the United States, except that such gains and losses shall be computed without regard to section 1202 (relating to deduction for capital gains) and such losses shall be determined without the benefits of the capital loss carryover provided in section 1212.

(b) No United States Business and Gross Income of More Than $15,400.—A nonresident alien individual not engaged in trade or business within the United States shall be taxable without regard to subsection (a) if during the taxable year the sum of the aggregate amount received from the sources specified in subsection (a) (1), plus the amount by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges (determined in accordance with subsection (a) (2)) is more than $15,400, except that—

(1) the gross income shall include only income from the sources specified in subsection (a) (1) plus any gain (to the extent provided in subchapter P; sec. 1201 and following, relating to capital gains and losses) from a sale or exchange of a capital asset if such gain would be taken into account were the tax being determined under subsection (a) (2);

(2) the deductions (other than the deduction for charitable contributions and gifts provided in section 873 (c)) shall be allowed only if and to the extent that they are properly allocable to the gross income from the sources specified in subsection (a), except that any loss from the sale or exchange of a capital asset shall be allowed (to the extent provided in subchapter P without the benefit of the capital loss carryover provided in section 1212) if such loss would be taken into account were the tax being determined under subsection (a) (2);

(3) the taxes imposed by this subtitle (under section 1, or under section 1201 (b)) shall, in no case, be less than 30 percent of the sum of—

(A) the aggregate amount received from the sources specified in subsection (a) (1), plus

(B) the amount, determined under subsection (a) (2), by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges.

(c) United States Business.—A nonresident alien individual engaged in trade or business within the United States shall be taxable without regard to subsection (a). For purposes of part I, this section, sections 881 and 882, and chapter 3, the term "engaged in trade or business within the United States" includes the performance of

personal services within the United States at any time within the taxable year, but does not include the performance of personal services—

(1) for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(2) for an office or place of business maintained by a domestic corporation in a foreign country or in a possession of the United States,

by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. Such term does not include the effecting, through a resident broker, commission agent, or custodian, of transactions in the United States in stocks or securities, or in commodities (if of a kind customarily dealt in on an organized commodity exchange, if the transaction is of the kind customarily consummated at such place, and if the alien, partnership, or corporation has no office or place of business in the United States at any time during the taxable year through which or by the direction of which such transactions in commodities are effected).

(d) DOUBLING OF TAX.—

For doubling of tax on citizens of certain foreign countries, see section 891.

SEC. 872. GROSS INCOME.

(a) GENERAL RULE.—In the case of a nonresident alien individual gross income includes only the gross income from sources within the United States.

(b) EXCLUSIONS.—The following items shall not be included in gross income of a nonresident alien individual, and shall be exempt from taxation under this subtitle:

(1) SHIPS UNDER FOREIGN FLAG.—Earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

(2) AIRCRAFT OF FOREIGN REGISTRY.—Earnings derived from the operation of aircraft registered under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

SEC. 873. DEDUCTIONS.

(a) GENERAL RULE.—In the case of a nonresident alien individual the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary or his delegate.

(b) LOSSES.—

(1) The deduction, for losses not connected with the trade or business if incurred in transactions entered into for profit, allowed by section 165 (c) (2) (relating to losses) shall be allowed whether or not connected with income from sources within the United States,

but only if the profit, if such transaction had resulted in a profit, would be taxable under this subtitle.

(2) The deduction for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 165 (c) (3), shall be allowed whether or not connected with income from sources within the United States, but only if the loss is of property within the United States.

(c) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income from sources within the United States, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States.

(d) PERSONAL EXEMPTION.—In the case of a nonresident alien individual who is not a resident of a contiguous country, only one exemption under section 151 shall be allowed as a deduction.

(e) STANDARD DEDUCTION.—

For disallowance of standard deduction, see section 142 (b) (1).

SEC. 874. ALLOWANCE OF DEDUCTIONS AND CREDITS.

(a) RETURN PREREQUISITE TO ALLOWANCE.—A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him in this subtitle only by filing or causing to be filed a true and accurate return of his total income received from all sources in the United States, in the manner prescribed in subtitle F (sec. 6001 and following, relating to procedure and administration), including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits. This subsection shall not be construed to deny the credits provided by sections 31 and 32 for tax withheld at the source.

(b) TAX WITHHELD AT SOURCE.—The benefit of the deduction for exemptions under section 151 may, in the discretion of the Secretary or his delegate, and under regulations prescribed by the Secretary or his delegate, be received by a nonresident alien individual entitled thereto, by filing a claim therefor with the withholding agent.

(c) FOREIGN TAX CREDIT NOT ALLOWED.—A nonresident alien individual shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

SEC. 875. PARTNERSHIPS.

For purposes of this subtitle, a nonresident alien individual shall be considered as being engaged in a trade or business within the United States if the partnership of which he is a member is so engaged.

SEC. 876. ALIEN RESIDENTS OF PUERTO RICO.

(a) NO APPLICATION TO CERTAIN ALIEN RESIDENTS OF PUERTO RICO.—This subpart shall not apply to an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, and such alien shall be subject to the tax imposed by section 1.

(b) CROSS REFERENCE.—

For exclusion from gross income of income derived from sources within Puerto Rico, see section 933.

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SEC. 877. FOREIGN EDUCATIONAL, CHARITABLE, AND CERTAIN OTHER EXEMPT ORGANIZATIONS.

For special provisions relating to unrelated business income of foreign educational, charitable, and other exempt trusts, see section 512 (a).

Subpart B—Foreign Corporations

Sec. 881. Tax on foreign corporations not engaged in business in United States.
Sec. 882. Tax on resident foreign corporations.
Sec. 883. Exclusions from gross income.
Sec. 884. Cross references.

SEC. 881. TAX ON FOREIGN CORPORATIONS NOT ENGAGED IN BUSINESS IN UNITED STATES.

(a) IMPOSITION OF TAX.—In the case of every foreign corporation not engaged in trade or business within the United States, there is hereby imposed for each taxable year, in lieu of the taxes imposed by section 11, a tax of 30 percent of the amount received from sources within the United States as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (including amounts described in section 631 (b) and (c) which are considered to be gains from the sale or exchange of capital assets).

(b) DOUBLING OF TAX.—

For doubling of tax on corporations of certain foreign countries, see section 891.

SEC. 882. TAX ON RESIDENT FOREIGN CORPORATIONS.

(a) IMPOSITION OF TAX.—A foreign corporation engaged in trade or business within the United States shall be taxable as provided in section 11.

(b) GROSS INCOME.—In the case of a foreign corporation, gross income includes only the gross income from sources within the United States.

(c) ALLOWANCE OF DEDUCTIONS AND CREDITS.—

(1) DEDUCTIONS ALLOWED ONLY IF RETURN FILED.—A foreign corporation shall receive the benefit of the deductions allowed to it in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return of its total income received from all sources in the United States, in the manner prescribed in subtitle F, including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions.

(2) ALLOCATION OF DEDUCTIONS.—In the case of a foreign corporation the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary or his delegate.

(3) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income from sources within the United States.

(4) FOREIGN TAX CREDIT.—Foreign corporations shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(d) RETURNS OF TAX BY AGENT.—If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return required under section 6012 shall be made by the agent.

SEC. 883. EXCLUSIONS FROM GROSS INCOME.

The following items shall not be included in gross income of a foreign corporation, and shall be exempt from taxation under this subtitle:

(1) SHIPS UNDER FOREIGN FLAG.—Earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

(2) AIRCRAFT OF FOREIGN REGISTRY.—Earnings derived from the operation of aircraft registered under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

SEC. 884. CROSS REFERENCES.

(1) For withholding at source of tax on income of foreign corporations, see section 1442.

(2) For rules applicable in determining whether any foreign corporation is engaged in trade or business within the United States, see section 871 (c).

(3) For special provisions relating to foreign insurance companies, see subchapter L (sec. 801 and following).

(4) For special provisions relating to unrelated business income of foreign educational, charitable, and certain other exempt organizations, see section 512 (a).

Subpart C—Miscellaneous Provisions

Sec. 891. Doubling of rates of tax on citizens and corporations of certain foreign countries.
Sec. 892. Income of foreign governments and of international organizations.
Sec. 893. Compensation of employees of foreign governments or international organizations.
Sec. 894. Income exempt under treaty.

SEC. 891. DOUBLING OF RATES OF TAX ON CITIZENS AND CORPORATIONS OF CERTAIN FOREIGN COUNTRIES.

Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 802, 821, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by such sections as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 percent of the taxable income of the taxpayer (computed without regard to the deductions allowable under section 151 and under part

VIII of subchapter B). Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.

SEC. 892. INCOME OF FOREIGN GOVERNMENTS AND OF INTERNATIONAL ORGANIZATIONS.

The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

SEC. 893. COMPENSATION OF EMPLOYEES OF FOREIGN GOVERNMENTS OR INTERNATIONAL ORGANIZATIONS.

(a) RULE FOR EXCLUSION.—Wages, fees, or salary of any employee of a foreign government or of an international organization (including a consular or other officer, or a nondiplomatic representative), received as compensation for official services to such government or international organization shall not be included in gross income and shall be exempt from taxation under this subtitle if—

(1) such employee is not a citizen of the United States, or is a citizen of the Republic of the Philippines (whether or not a citizen of the United States); and

(2) in the case of an employee of a foreign government, the services are of a character similar to those performed by employees of the Government of the United States in foreign countries; and

(3) in the case of an employee of a foreign government, the foreign government grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country.

(b) CERTIFICATE BY SECRETARY OF STATE.—The Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

SEC. 894. INCOME EXEMPT UNDER TREATY.

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 this subtitle.

PART III—INCOME FROM SOURCES WITHOUT THE UNITED STATES

Subpart A. Foreign tax credit.
Subpart B. Earned income of citizens of United States.
Subpart C. Western Hemisphere trade corporations.
Subpart D. Possessions of the United States.
Subpart E. China Trade Act corporations.

Subpart A—Foreign Tax Credit

Sec. 901. Taxes of foreign countries and of possessions of United States.
Sec. 902. Credit for corporate stockholder in foreign corporation.
Sec. 903. Credit for taxes in lieu of income, etc., taxes.
Sec. 904. Limitation on credit.
Sec. 905. Applicable rules.

SEC. 901. TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES.

(a) ALLOWANCE OF CREDIT.—If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under section 902. Such choice may be made or changed at any time prior to the expiration of the period prescribed for making a claim for credit or refund of the tax against which the credit is allowable. The credit shall not be allowed against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1333 (relating to war loss recoveries), or against the personal holding company tax imposed by section 541.

(b) AMOUNT ALLOWED.—Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) CITIZENS AND DOMESTIC CORPORATIONS.—In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) RESIDENT OF THE UNITED STATES OR PUERTO RICO.—In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) ALIEN RESIDENT OF THE UNITED STATES OR PUERTO RICO.—In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) PARTNERSHIPS AND ESTATES.—In the case of any individual described in paragraph (1), (2), or (3), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(c) CORPORATIONS TREATED AS FOREIGN.—For purposes of this subpart, the following corporations shall be treated as foreign corporations:

(1) a corporation entitled to the benefits of section 931, by reason of receiving a large percentage of its gross income from sources within a possession of the United States; and

(2) a corporation organized under the China Trade Act, 1922 (15 U. S. C., chapter 4), and entitled to the deduction provided in section 941.

(d) CROSS REFERENCE.—

(1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see section 164.

(2) For right of each partner to make election under this section, see section 703 (b).

(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642 (a) (2).

SEC. 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

(a) TREATMENT OF TAXES PAID BY FOREIGN CORPORATION.—For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits.

(b) FOREIGN SUBSIDIARY OF FOREIGN CORPORATION.—If such foreign corporation owns 50 percent or more of the voting stock of another foreign corporation from which it receives dividends in any taxable year, it shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid by such other foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of the corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits.

(c) APPLICABLE RULES.—

(1) The term "accumulated profits", when used in this section in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income; and the Secretary or his delegate shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings.

(2) In the case of a foreign corporation, the income, war profits, and excess profits taxes of which are determined on the basis of an accounting period of less than 1 year, the word "year" as used in this subsection shall be construed to mean such accounting period.

(d) SPECIAL RULES FOR CERTAIN WHOLLY-OWNED FOREIGN CORPORATIONS.—For purposes of this subtitle, if—

(1) a domestic corporation owns, directly or indirectly, 100 percent of all classes of outstanding stock of a foreign corporation engaged in manufacturing, production, or mining,

(2) such domestic corporation receives property in the form of a royalty or compensation from such foreign corporation pursuant to any form of contractual arrangement under which the domestic corporation agrees to furnish services or property in consideration for the property so received, and

(3) such contractual arrangement provides that the property so received by such domestic corporation shall be accepted by such domestic corporation in lieu of dividends and that such foreign corporation shall neither declare nor pay any dividends of any kind in any calendar year in which such property is paid to such domestic corporation by such foreign corporation,

then the excess of the fair market value of such property so received by such domestic corporation over the cost to such domestic corporation of the property and services so furnished by such domestic corporation shall be treated as a distribution by such foreign corporation to such domestic corporation, and for purposes of section 301, the amount of such distribution shall be such excess, in lieu of any amount otherwise determined under section 301 without regard to this subsection; and the basis of such property so received by such domestic corporation shall be the fair market value of such property, in lieu of the basis otherwise determined under section 301 (d) without regard to this subsection.

SEC. 903. CREDIT FOR TAXES IN LIEU OF INCOME, ETC., TAXES.

For purposes of this subpart and of section 164 (b), the term "income, war profits, and excess profits taxes" shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

SEC. 904. LIMITATION ON CREDIT.

(a) LIMITATION.—The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion

of the tax against which such credit is taken which the taxpayer's taxable income from sources within such country (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

(b) TAXABLE INCOME FOR PURPOSE OF COMPUTING LIMITATION.—For purposes of computing the limitation under subsection (a), the taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642 (b).

SEC. 905. APPLICABLE RULES.

(a) YEAR IN WHICH CREDIT TAKEN.—The credits provided in this subpart may, at the option of the taxpayer and irrespective of the method of accounting employed in keeping his books, be taken in the year in which the taxes of the foreign country or the possession of the United States accrued, subject, however, to the conditions prescribed in subsection (c). If the taxpayer elects to take such credits in the year in which the taxes of the foreign country or the possession of the United States accrued, the credits for all subsequent years shall be taken on the same basis, and no portion of any such taxes shall be allowed as a deduction in the same or any succeeding year.

(b) PROOF OF CREDITS.—The credits provided in this subpart shall be allowed only if the taxpayer establishes to the satisfaction of the Secretary or his delegate—

(1) the total amount of income derived from sources without the United States, determined as provided in part I,

(2) the amount of income derived from each country, the tax paid or accrued to which is claimed as a credit under this subpart, such amount to be determined under regulations prescribed by the Secretary or his delegate, and

(3) all other information necessary for the verification and computation of such credits.

(c) ADJUSTMENTS ON PAYMENT OF ACCRUED TAXES.—If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary or his delegate, who shall redetermine the amount of the tax for the year or years affected. The amount of tax due on such redetermination, if any, shall be paid by the taxpayer on notice and demand by the Secretary or his delegate, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with subchapter B of chapter 66 (sec. 6511 and following). In the case of such a tax accrued but not paid, the Secretary or his delegate, as a condition precedent to the allowance of this credit, may require the taxpayer to give a bond, with sureties satisfactory to and to be approved by the Secretary or his delegate, in such sum as the Secretary or his delegate may require, conditioned on the payment by the taxpayer of any amount of tax found due on any such redetermination; and the bond herein prescribed shall contain such further conditions as the Secretary or his delegate may require. In such redetermination by the Secretary or his delegate of the amount of tax due from the taxpayer for the year or years affected by a refund, the amount of the taxes refunded for which credit has been allowed under this section shall be reduced by the amount of any tax described

in section 901 imposed by the foreign country or possession of the United States with respect to such refund; but no credit under this subpart, and no deduction under section 164 (relating to deduction for taxes) shall be allowed for any taxable year with respect to such tax imposed on the refund. No interest shall be assessed or collected on any amount of tax due on any redetermination by the Secretary or his delegate, resulting from a refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

Subpart B—Earned Income of Citizens of United States

Sec. 911. Earned income from sources without the United States.
Sec. 912. Exemption for certain allowances.

SEC. 911. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.

(a) GENERAL RULE.—The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) BONA FIDE RESIDENT OF FOREIGN COUNTRY.—In the case of an individual citizen of the United States, who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) PRESENCE IN FOREIGN COUNTRY FOR 17 MONTHS.—In the case of an individual citizen of the United States, who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or an agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph. If the 18-month period includes the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed $20,000. If the 18-month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year.

(b) DEFINITION OF EARNED INCOME.—For purposes of this section, the term "earned income" means wages, salaries, or professional

fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.

SEC. 912. EXEMPTION FOR CERTAIN ALLOWANCES.

The following items shall not be included in gross income, and shall be exempt from taxation under this subtitle:

(1) COST-OF-LIVING ALLOWANCES.—In the case of civilian officers or employees of the Government of the United States stationed outside continental United States, amounts received as cost-of-living allowances in accordance with regulations approved by the President.

(2) FOREIGN SERVICE ALLOWANCES.—In the case of an officer or employee of the Foreign Service of the United States, amounts received by such officer or employee as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946 (22 U. S. C. 1131–1158).

Subpart C—Western Hemisphere Trade Corporations

Sec. 921. Definition of Western Hemisphere trade corporations.
Sec. 922. Special deduction.

SEC. 921. DEFINITION OF WESTERN HEMISPHERE TRADE CORPORATIONS.

For purposes of this subtitle, the term "Western Hemisphere trade corporation" means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:

(1) if 95 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and

(2) if 90 percent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

For any taxable year beginning prior to January 1, 1954, the determination as to whether any corporation meets the requirements of section 109 of the Internal Revenue Code of 1939 shall be made as if this section had not been enacted and without inferences drawn from the fact that this section is not expressly made applicable with respect to taxable years beginning prior to January 1, 1954.

SEC. 922. SPECIAL DEDUCTION.

In the case of a Western Hemisphere trade corporation there shall be allowed as a deduction in computing taxable income an amount computed as follows—

(1) First determine the taxable income of such corporation computed without regard to this section.

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) the numerator of which is 14 percent, and

(B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

Subpart D—Possessions of the United States

Sec. 931. Income from sources within possessions of the United States.
Sec. 932. Citizens of possessions of the United States.
Sec. 933. Income from sources within Puerto Rico.

SEC. 931. INCOME FROM SOURCES WITHIN POSSESSIONS OF THE UNITED STATES.

(a) General Rule.—In the case of citizens of the United States or domestic corporations, gross income means only gross income from sources within the United States if the conditions of both paragraph (1) and paragraph (2) are satisfied:

(1) Three-year period.—If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) Trade or business.—If—

(A) in the case of such corporation, 50 percent or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(B) in the case of such citizen, 50 percent or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) Amounts Received in United States.—Notwithstanding subsection (a), there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) Definition.—For purposes of this section, the term "possession of the United States" does not include the Virgin Islands of the United States, and such term when used with respect to citizens of the United States does not include Puerto Rico.

(d) Deductions.—

(1) Citizens of the United States entitled to the benefits of this section shall have the same deductions as are allowed by section 873

in the case of a nonresident alien individual engaged in trade or business within the United States.

(2) Domestic corporations entitled to the benefits of this section shall have the same deductions as are allowed by section 882 (c) in the case of a foreign corporation engaged in trade or business within the United States.

(e) DEDUCTION FOR PERSONAL EXEMPTION.—A citizen of the United States entitled to the benefits of this section shall be allowed a deduction for only one exemption under section 151.

(f) ALLOWANCE OF DEDUCTIONS AND CREDITS.—Persons entitled to the benefits of this section shall receive the benefit of the deductions and credits allowed to them in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return of their total income received from all sources in the United States, in the manner prescribed in subtitle F, including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits.

(g) FOREIGN TAX CREDIT.—Persons entitled to the benefits of this section shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(h) INTERNEES.—In the case of a citizen of the United States interned by the enemy while serving as an employee within a possession of the United States—

(1) if such citizen was confined in any place not within a possession of the United States, such place of confinement shall, for purposes of this section, be considered as within a possession of the United States; and

(2) subsection (b) shall not apply to any compensation received within the United States by such citizen attributable to the period of time during which such citizen was interned by the enemy.

(i) EMPLOYEES OF THE UNITED STATES.—For purposes of this section, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

SEC. 932. CITIZENS OF POSSESSIONS OF THE UNITED STATES.

(a) GENERAL RULE.—Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States shall be subject to taxation under this subtitle only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources. This section shall have no application in the case of a citizen of Puerto Rico.

(b) VIRGIN ISLANDS.—Nothing in this section shall be construed to alter or amend the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes", approved July 12, 1921 (48 U. S. C. 1397), relating to the imposition of income taxes in the Virgin Islands of the United States.

(c) GUAM.—

For applicability of United States income tax laws in Guam, see section 31 of the Act of August 1, 1950 (48 U. S. C. 1421i); for disposition of the proceeds of such taxes, see section 30 of such Act (48 U. S. C. 1421h).

SEC. 933. INCOME FROM SOURCES WITHIN PUERTO RICO.

The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) RESIDENT OF PUERTO RICO FOR ENTIRE TAXABLE YEAR.—In the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico (except amounts received for services performed as an employee of the United States or any agency thereof); but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction under section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) TAXABLE YEAR OF CHANGE OF RESIDENCE FROM PUERTO RICO.—In the case of an individual citizen of the United States who has been a bona fide resident of Puerto Rico for a period of at least 2 years before the date on which he changes his residence from Puerto Rico, income derived from sources therein (except amounts received for services performed as an employee of the United States or any agency thereof) which is attributable to that part of such period of Puerto Rican residence before such date; but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction for personal exemptions under section 151) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

Subpart E—China Trade Act Corporations

Sec. 941. Special deduction for China Trade Act corporations.
Sec. 942. Disallowance of foreign tax credit.
Sec. 943. Exclusion of dividends to residents of Formosa or Hong Kong.

SEC. 941. SPECIAL DEDUCTION FOR CHINA TRADE ACT CORPORATIONS.

(a) ALLOWANCE OF DEDUCTION.—For purposes only of the taxes imposed by section 11, there shall be allowed, in the case of a corporation organized under the China Trade Act, 1922 (15 U. S. C. ch. 4, sec. 141 and following), in addition to the deductions from taxable income otherwise allowed such corporation, a special deduction, in computing the taxable income, of an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a similar manner to that provided in part I) which the par value of the shares of stock of the corporation owned on the last day of the taxable year by—

(1) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and

(2) individual citizens of the United States wherever resident,

bears to the par value of the whole number of shares of stock of the corporation outstanding on such date. In no case shall the diminu-

tion, by reason of such special deduction, of the taxes imposed by section 11 (computed without regard to this section) exceed the amount of the special dividend certified under subsection (b) of this section.

(b) SPECIAL DIVIDEND.—The special deduction provided in subsection (a) shall not be allowed unless the Secretary of Commerce has certified to the Secretary of the Treasury or his delegate—

(1) the amount which, during the year ending on the date fixed by law for filing the return, the corporation has distributed as a special dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation;

(2) that such special dividend was in addition to all other amounts, payable or to be payable to such persons or for their benefit, by reason of their interest in the corporation; and

(3) that such distribution has been made to or for the benefit of such persons in proportion to the par value of the shares of stock of the corporation owned by each; except that if the corporation has more than one class of stock, the certificates shall contain a statement that the articles of incorporation provide a method for the apportionment of such special dividend among such persons, and that the amount certified has been distributed in accordance with the method so provided.

(c) OWNERSHIP OF STOCK.—For purposes of this section, shares of stock of a corporation shall be considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

SEC. 942. DISALLOWANCE OF FOREIGN TAX CREDIT.

A corporation organized under the China Trade Act, 1922, shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

SEC. 943. EXCLUSION OF DIVIDENDS TO RESIDENTS OF FORMOSA OR HONG KONG

Amounts distributed as dividends to or for the benefit of any person by a corporation organized under the China Trade Act, 1922, shall not be included in gross income and shall be exempt from taxation under this subtitle if, at the time of such distribution, such person is a resident of Formosa or Hong Kong, and the equitable right to the income of the shares of stock of the corporation is in good faith vested in him.

Subchapter O—Gain or Loss on Disposition of Property

Part I. Determination of amount of and recognition of gain or loss.
Part II. Basis rules of general application.
Part III. Common nontaxable exchanges.
Part IV. Special rules.
Part V. Changes to effectuate F. C. C. policy.
Part VI. Exchanges in obedience to S. E. C. orders.
Part VII. Wash sales of stock or securities.

PART I—DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

Sec. 1001. Determination of amount of and recognition of gain or loss.
Sec. 1002. Recognition of gain or loss.

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) AMOUNT REALIZED.—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. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164 (d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164 (d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) RECOGNITION OF GAIN OR LOSS.—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

(d) INSTALLMENT SALES.—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

SEC. 1002. RECOGNITION OF GAIN OR LOSS.

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

PART II—BASIS RULES OF GENERAL APPLICATION

Sec. 1011. Adjusted basis for determining gain or loss.
Sec. 1012. Basis of property—cost.
Sec. 1013. Basis of property included in inventory.
Sec. 1014. Basis of property acquired from a decedent.
Sec. 1015. Basis of property acquired by gifts and transfers in trust.
Sec. 1016. Adjustments to basis.
Sec. 1017. Discharge of indebtedness.
Sec. 1018. Adjustment of capital structure before September 22, 1938.
Sec. 1019. Property on which lessee has made improvements.
Sec. 1020. Election in respect of depreciation, etc., allowed before 1952.
Sec. 1021. Sale of annuities.
Sec. 1022. Cross references.

SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164 (d) as imposed on the taxpayer.

SEC. 1013. BASIS OF PROPERTY INCLUDED IN INVENTORY.

If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

SEC. 1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

(a) In General.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under either section 2032 or section 811 (j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections.

(b) Property Acquired From the Decedent.—For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;

(2) Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;

(4) Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;

(5) In the case of decedents dying after August 26, 1937, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent's death or the basis in the hands of the decedent, whichever is lower;

(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

(7) In the case of decedents dying after October 21, 1942, and on or before December 31, 1947, such part of any property, representing the surviving spouse's one-half share of property held by a decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, as was included in determining the value of the gross estate of the decedent, if a tax under chapter 3 of the Internal Revenue Code of 1939 was payable on the transfer of the net estate of the decedent. In such case, nothing in this paragraph shall reduce the basis below that which would exist if the Revenue Act of 1948 had not been enacted;

(8) In the case of decedents dying after December 31, 1950, and before January 1, 1954, property which represents the survivor's interest in a joint and survivor's annuity if the value of any part of such interest was required to be included in determining the value of decedent's gross estate under section 811 of the Internal Revenue Code of 1939;

(9) In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason

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thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Such basis shall be applicable to the property commencing on the death of the decedent. This paragraph shall not apply to—

(A) annuities described in section 72;

(B) property to which paragraph (5) would apply if the property had been acquired by bequest; and

(C) property described in any other paragraph of this subsection.

(c) PROPERTY REPRESENTING INCOME IN RESPECT OF A DECEDENT.—This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

(d) EMPLOYEE STOCK OPTIONS.—This section shall not apply to restricted stock options described in section 421 which the employee has not exercised at death.

SEC. 1015. BASIS OF PROPERTY ACQUIRED BY GIFTS AND TRANSFERS IN TRUST.

(a) GIFTS AFTER DECEMBER 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary or his delegate shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary or his delegate finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary or his delegate as of the date or approximate date at which, according to the best information that the Secretary or his delegate is able to obtain, such property was acquired by such donor or last preceding owner.

(b) TRANSFER IN TRUST AFTER DECEMBER 31, 1920.—If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer under the law applicable to the year in which the transfer was made.

(c) GIFT OR TRANSFER IN TRUST BEFORE JANUARY 1, 1921.—If the property was acquired by gift or transfer in trust on or before

December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under section 167 (b) (1). Subparagraph (B) of this paragraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under section 1020. Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(3) in respect of any period—

(A) before March 1, 1913, and

(B) since February 28, 1913, during which such property was held by a person or an organization not subject to income taxation under this chapter or prior income tax laws,

for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(4) in the case of stock (to the extent not provided for in the foregoing paragraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057), or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921);

(5) in the case of any bond (as defined in section 171 (d)) the interest on which is wholly exempt from the tax imposed by this subtitle, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 171 (a) (2), and in the case of any other bond (as defined in section 171 (d)) to the extent of the deductions allowable pursuant to section 171 (a) (1) with respect thereto;

(6) in the case of any short-term municipal bond (as defined in section 75 (b)), to the extent provided in section 75 (a) (2);

(7) in the case of a residence the acquisition of which resulted, under section 1034, in the nonrecognition of any part of the gain realized on the sale, exchange, or involuntary conversion of another residence, to the extent provided in section 1034 (e);

(8) in the case of property pledged to the Commodity Credit Corporation, to the extent of the amount received as a loan from the Commodity Credit Corporation and treated by the taxpayer as income for the year in which received pursuant to section 77, and to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability;

(9) for amounts allowed as deductions as deferred expenses under section 616 (b) (relating to certain expenditures in the development of mines) and resulting in a reduction of the taxpayer's taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(10) for amounts allowed as deductions as deferred expenses under section 615 (b) (relating to certain exploration expenditures) and resulting in a reduction of the taxpayer's taxes under this subtitle but not less than the amounts allowable under such section for the taxable year and prior years;

(11) for deductions to the extent disallowed under section 268 (relating to sale of land with unharvested crops), notwithstanding the provisions of any other paragraph of this subsection;

(12) to the extent provided in section 28 (h) of the Internal Revenue Code of 1939 in the case of amounts specified in a shareholder's consent made under section 28 of such code;

(13) to the extent provided in section 551 (f) in the case of the stock of United States shareholders in a foreign personal holding company;

(14) for amounts allowed as deductions as deferred expenses under section 174 (b) (1) (relating to research and experimental expenditures) and resulting in a reduction of the taxpayers' taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(15) for deductions to the extent disallowed under section 272 (relating to disposal of coal), notwithstanding the provisions of any other paragraph of this subsection.

(b) SUBSTITUTED BASIS.—Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, then the adjustments provided in subsection (a) shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. A similar rule shall be applied in the case of a series of substituted bases.

The term "substituted basis" as used in this section means a basis determined under any provision of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses), or under any corresponding provision of a prior income tax law, providing that the basis shall be determined—

(1) by reference to the basis in the hands of a transferor, donor, or grantor, or

(2) by reference to other property held at any time by the person for whom the basis is to be determined.

(c) SEPARATE MINERAL INTERESTS TREATED AS ONE PROPERTY.—

For treatment of separate mineral interests as one property, see section 614.

SEC. 1017. DISCHARGE OF INDEBTEDNESS.

Where any amount is excluded from gross income under section 108 (a) (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 108 (a)) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary or his delegate) in effect at the time of the filing of the consent by the taxpayer referred to in section 108 (a). The reduction shall be made as of the first day of the taxable year in which the discharge occurred, except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began.

SEC. 1018. ADJUSTMENT OF CAPITAL STRUCTURE BEFORE SEPTEMBER 22, 1938.

Where a plan of reorganization of a corporation, approved by the court in a proceeding under section 77B of the National Bankruptcy Act, as amended (48 Stat. 912), is consummated by adjustment of the capital or debt structure of such corporation without the transfer of its assets to another corporation, and a final judgment or decree in such proceeding has been entered before September 22, 1938, then the provisions of section 270 of the Bankruptcy Act, as amended (54 Stat. 709; 11 U. S. C. 670), shall not apply in respect of the property of such corporation. For purposes of this section, the term "reorganization" shall not be limited by the definition of such term in section 112 (g) of the Internal Revenue Code of 1939.

SEC. 1019. PROPERTY ON WHICH LESSEE HAS MADE IMPROVEMENTS.

Neither the basis nor the adjusted basis of any portion of real property shall, in the case of the lessor of such property, be increased or diminished on account of income derived by the lessor in respect of such property and excludable from gross income under section 109 (relating to improvements by lessee on lessor's property). If an amount representing any part of the value of real property attributable to buildings erected or other improvements made by a lessee

in respect of such property was included in gross income of the lessor for any taxable year beginning before January 1, 1942, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income.

SEC. 1020. ELECTION IN RESPECT OF DEPRECIATION, ETC., ALLOWED BEFORE 1952.

Any person may elect to have subparagraph (B) of section 1016 (a) (2) apply in respect of periods since February 28, 1913, and before January 1, 1952. Such an election shall be made in such manner as the Secretary or his delegate may by regulations prescribe and shall be irrevocable when made, except that an election made on or before December 31, 1952, may be revoked at any time before January 1, 1955. A revocation of an election shall be made in such manner as the Secretary or his delegate may by regulations prescribe, and no election may be made by any person after he has so revoked an election. The election shall apply in respect of all property held by the person making the election at any time on or before December 31, 1952, and in respect of all periods since February 28, 1913, and before January 1, 1952, during which such person held such property or for which adjustments must be made under section 1016 (b). An election or a revocation of an election by a transferor, donor, or grantor made after the date of the transfer, gift, or grant of property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. No election may be made under this section after December 31, 1954.

SEC. 1021. SALE OF ANNUITIES.

In case of the sale of an annuity contract, the adjusted basis shall in no case be less than zero.

SEC. 1022. CROSS REFERENCES.

(1) For certain distributions by a corporation which are applied in reduction of basis of stock, see section 301 (c) (2).

(2) For basis of property in case of certain reorganizations and arrangements under the Bankruptcy Act, see sections 270, 396, and 522 of that Act, as amended (11 U. S. C. 670, 796, 922).

(3) For basis in case of construction of new vessels, see section 511 of the Merchant Marine Act, 1936, as amended (46 U. S. C. 1161).

(4) For rules applicable in case of payments in violation of Defense Production Act of 1950, as amended, see section 405 of that Act.

PART III—COMMON NONTAXABLE EXCHANGES

Sec. 1031. Exchange of property held for productive use or investment.
Sec. 1032. Exchange of stock for property.
Sec. 1033. Involuntary conversions.
Sec. 1034. Sale or exchange of residence.
Sec. 1035. Certain exchanges of insurance policies.
Sec. 1036. Stock for stock of same corporation.

SEC. 1031. EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT.

(a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged

solely for property of a like kind to be held either for productive use in trade or business or for investment.

(b) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a), of section 1035 (a), or of section 1036 (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, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) LOSS FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a), of section 1035 (a), or of section 1036 (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.

(d) BASIS.—If property was acquired on an exchange described in this section, section 1035 (a), or section 1036 (a), then the basis shall be the same as that of the property exchanged decreased in the amount of any money received by the taxpayer and increased in the amount of gain to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035 (a), or section 1036 (a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035 (a), and section 1036 (a), where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall be considered as money received by the taxpayer on the exchange.

SEC. 1032. EXCHANGE OF STOCK FOR PROPERTY.

(a) NONRECOGNITION OF GAIN OR LOSS.—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

(b) BASIS.—

For basis of property acquired by a corporation in certain exchanges for its stock, see section 362.

SEC. 1033. INVOLUNTARY CONVERSIONS.

(a) GENERAL RULE.—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) CONVERSION INTO SIMILAR PROPERTY.—Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) CONVERSION INTO MONEY WHERE DISPOSITION OCCURRED PRIOR TO 1951.—Into money, and the disposition of the converted property occurred before January 1, 1951, no gain shall be recognized

if such money is forthwith in good faith, under regulations prescribed by the Secretary or his delegate, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund. If any part of the money is not so expended, the gain shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain). For purposes of this paragraph and paragraph (3), the term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(3) CONVERSION INTO MONEY WHERE DISPOSITION OCCURRED AFTER 1950.—Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) NONRECOGNITION OF GAIN.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. For purposes of this paragraph—

(i) no property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) the taxpayer shall be considered to have purchased property or stock only if, but for the provisions of subsection (c) of this section, the unadjusted basis of such property or stock would be its cost within the meaning of section 1012.

(B) PERIOD WITHIN WHICH PROPERTY MUST BE REPLACED.—The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—

(i) one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or

(ii) subject to such terms and conditions as may be specified by the Secretary or his delegate, at the close of such later date as the Secretary or his delegate may designate on application by the taxpayer. Such application shall be made at such time

and in such manner as the Secretary or his delegate may by regulations prescribe.

(C) TIME FOR ASSESSMENT OF DEFICIENCY ATTRIBUTABLE TO GAIN UPON CONVERSION.—If a taxpayer has made the election provided in subparagraph (A), then—

(i) the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain on such conversion is realized, attributable to such gain shall not expire prior to the expiration of 3 years from the date the Secretary or his delegate is notified by the taxpayer (in such manner as the Secretary or his delegate may by regulations prescribe) of the replacement of the converted property or of an intention not to replace, and

(ii) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212 (c) or the provisions of any other law or rule of law which would otherwise prevent such assessment.

(D) TIME FOR ASSESSMENT OF OTHER DEFICIENCIES ATTRIBUTABLE TO ELECTION.—If the election provided in subparagraph (A) is made by the taxpayer and such other property or such stock was purchased before the beginning of the last taxable year in which any part of the gain upon such conversion is realized, any deficiency, to the extent resulting from such election, for any taxable year ending before such last taxable year may be assessed (notwithstanding the provisions of section 6212 (c) or 6501 or the provisions of any other law or rule of law which would otherwise prevent such assessment) at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed.

(b) RESIDENCE OF TAXPAYER.—Subsection (a) shall not apply, in the case of property used by the taxpayer as his principal residence, if the destruction, theft, seizure, requisition, or condemnation of the residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954.

(c) BASIS OF PROPERTY ACQUIRED THROUGH INVOLUNTARY CONVERSION.—If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in subsection (a) (1) or (2), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made. This subsection shall not apply in respect of property acquired as a result of a compulsory or involuntary conversion of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954. In the case of property purchased by the taxpayer in a transaction described in

subsection (a) (3) which resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.

(d) PROPERTY SOLD PURSUANT TO RECLAMATION LAWS.—For purposes of this subtitle, if property lying within an irrigation project is sold or otherwise disposed of in order to conform to the acreage limitation provisions of Federal reclamation laws, such sale or disposition shall be treated as an involuntary conversion to which this section applies.

(e) LIVESTOCK DESTROYED BY DISEASE.—For purposes of this subtitle, if livestock are destroyed by or on account of disease, or are sold or exchanged because of disease, such destruction or such sale or exchange shall be treated as an involuntary conversion to which this section applies.

(f) CROSS REFERENCES.—

(1) For determination of the period for which the taxpayer has held property involuntarily converted, see section 1223.

(2) For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231 (a).

SEC. 1034. SALE OR EXCHANGE OF RESIDENCE.

(a) NONRECOGNITION OF GAIN.—If property (in this section called "old residence") used by the taxpayer as his principal residence is sold by him after December 31, 1953, and, within a period beginning 1 year before the date of such sale and ending 1 year after such date, property (in this section called "new residence") is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price (as defined in subsection (b)) of the old residence exceeds the taxpayer's cost of purchasing the new residence.

(b) ADJUSTED SALES PRICE DEFINED.—

(1) IN GENERAL.—For purposes of this section, the term "adjusted sales price" means the amount realized, reduced by the aggregate of the expenses for work performed on the old residence in order to assist in its sale.

(2) LIMITATIONS.—The reduction provided in paragraph (1) applies only to expenses—

(A) for work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into;

(B) which are paid on or before the 30th day after the date of the sale of the old residence; and

(C) which are—

(i) not allowable as deductions in computing taxable income under section 63 (a) (defining taxable income), and

(ii) not taken into account in computing the amount realized from the sale of the old residence.

(3) EFFECTIVE DATE.—The reduction provided in paragraph (1) applies to expenses for work performed in any taxable year (whether beginning before, on, or after January 1, 1954), but only in the case

of a sale or exchange of an old residence which occurs after December 31, 1953.

(c) RULES FOR APPLICATION OF SECTION.—For purposes of this section:

(1) An exchange by the taxpayer of his residence for other property shall be treated as a sale of such residence, and the acquisition of a residence on the exchange of property shall be treated as a purchase of such residence.

(2) A residence any part of which was constructed or reconstructed by the taxpayer shall be treated as purchased by the taxpayer. In determining the taxpayer's cost of purchasing a residence, there shall be included only so much of his cost as is attributable to the acquisition, construction, reconstruction, and improvements made which are properly chargeable to capital account, during the period specified in subsection (a).

(3) If a residence is purchased by the taxpayer before the date of his sale of the old residence, the purchased residence shall not be treated as his new residence if sold or otherwise disposed of by him before the date of the sale of the old residence.

(4) If the taxpayer, during the period described in subsection (a), purchases more than one residence which is used by him as his principal residence at some time within 1 year after the date of the sale of the old residence, only the last of such residences so used by him after the date of such sale shall constitute the new residence.

(5) In the case of a new residence the construction of which was commenced by the taxpayer before the expiration of one year after the date of the sale of the old residence, the period specified in subsection (a), and the 1 year referred to in paragraph (4) of this subsection, shall be treated as including a period of 18 months beginning with the date of the sale of the old residence.

(d) LIMITATION.—Subsection (a) shall not apply with respect to the sale of the taxpayer's residence if within 1 year before the date of such sale the taxpayer sold at a gain other property used by him as his principal residence, and any part of such gain was not recognized by reason of subsection (a) or section 112 (n) of the Internal Revenue Code of 1939.

(e) BASIS OF NEW RESIDENCE.—Where the purchase of a new residence results, under subsection (a) or under section 112 (n) of the Internal Revenue Code of 1939, in the nonrecognition of gain on the sale of an old residence, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain not so recognized on the sale of the old residence. For this purpose, the amount of the gain not so recognized on the sale of the old residence includes only so much of such gain as is not recognized by reason of the cost, up to such time, of purchasing the new residence.

(f) TENANT-STOCKHOLDER IN A COOPERATIVE HOUSING CORPORATION.—For purposes of this section, section 1016 (relating to adjustments to basis), and section 1223 (relating to holding period), references to property used by the taxpayer as his principal residence, and references to the residence of a taxpayer, shall include stock held by a tenant-stockholder (as defined in section 216, relating to deduction

for amounts representing taxes and interest paid to a cooperative housing corporation) in a cooperative housing corporation (as defined in such section) if—

(1) in the case of stock sold, the house or apartment which the taxpayer was entitled to occupy as such stockholder was used by him as his principal residence, and

(2) in the case of stock purchased, the taxpayer used as his principal residence the house or apartment which he was entitled to occupy as such stockholder.

(g) HUSBAND AND WIFE.—If the taxpayer and his spouse, in accordance with regulations which shall be prescribed by the Secretary or his delegate pursuant to this subsection, consent to the application of paragraph (2) of this subsection, then—

(1) for purposes of this section—

(A) the taxpayer's adjusted sales price of the old residence is the adjusted sales price (of the taxpayer, or of the taxpayer and his spouse) of the old residence, and

(B) the taxpayer's cost of purchasing the new residence is the cost (to the taxpayer, his spouse, or both) of purchasing the new residence (whether held by the taxpayer, his spouse, or the taxpayer and his spouse); and

(2) so much of the gain on the sale of the old residence as is not recognized solely by reason of this subsection, and so much of the adjustment under subsection (e) to the basis of the new residence as results solely from this subsection shall be allocated between the taxpayer and his spouse as provided in such regulations.

This subsection shall apply only if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence. In case the taxpayer and his spouse do not consent to the application of paragraph (2) of this subsection then the recognition of gain on the sale of the old residence shall be determined under this section without regard to the rules provided in this subsection.

(h) MEMBERS OF ARMED FORCES.—The running of any period of time specified in subsection (a) or (c) (other than the 1 year referred to in subsection (c) (4)) shall be suspended during any time that the taxpayer (or his spouse if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence) serves on extended active duty with the Armed Forces of the United States after the date of the sale of the old residence and during an induction period (as defined in section 112 (c) (5)) except that any such period of time as so suspended shall not extend beyond the date 4 years after the date of the sale of the old residence. For purposes of this subsection, the term "extended active duty" means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

(i) SPECIAL RULE FOR INVOLUNTARY CONVERSIONS.—

(1) IN GENERAL.—For purposes of this section, the destruction, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof—

(A) if occurring after December 31, 1950, and before January 1, 1954, shall be treated as the sale of such property; and

(B) if occurring after December 31, 1953, shall not be treated as the sale of such property.

(2) CROSS REFERENCE.—

For treatment of residences involuntarily converted after December 31, 1953, see section 1033 (relating to involuntary conversions).

(j) STATUTE OF LIMITATIONS.—If after December 31, 1950, the taxpayer during a taxable year sells at a gain property used by him as his principal residence, then—

(1) the statutory period for the assessment of any deficiency attributable to any part of such gain shall not expire before the expiration of 3 years from the date the Secretary or his delegate is notified by the taxpayer (in such manner as the Secretary or his delegate may by regulations prescribe) of—

(A) the taxpayer's cost of purchasing the new residence which the taxpayer claims results in nonrecognition of any part of such gain,

(B) the taxpayer's intention not to purchase a new residence within the period specified in subsection (a), or

(C) a failure to make such purchase within such period; and

(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

SEC. 1035. CERTAIN EXCHANGES OF INSURANCE POLICIES.

(a) GENERAL RULES.—No gain or loss shall be recognized on the exchange of—

(1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; or

(2) a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (B) for an annuity contract; or

(3) an annuity contract for an annuity contract.

(b) DEFINITIONS.—For the purpose of this section—

(1) ENDOWMENT CONTRACT.—A contract of endowment insurance is a contract with a life insurance company as defined in section 801 which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

(2) ANNUITY CONTRACT.—An annuity contract is a contract to which paragraph (1) applies but which may be payable during the life of the annuitant only in installments.

(3) LIFE INSURANCE CONTRACT.—A contract of life insurance is a contract to which paragraph (1) applies but which is not ordinarily payable in full during the life of the insured.

(c) CROSS REFERENCES.—

(1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

SEC. 1036. STOCK FOR STOCK OF SAME CORPORATION.

(a) GENERAL RULE.—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(b) CROSS REFERENCES.—

(1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

PART IV—SPECIAL RULES

Sec. 1051. Property acquired during affiliation.
Sec. 1052. Basis established by the Revenue Act of 1932 or 1934 or by the Internal Revenue Code of 1939.
Sec. 1053. Property acquired before March 1, 1913.
Sec. 1054. Cross references.

SEC. 1051. PROPERTY ACQUIRED DURING AFFILIATION.

In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Secretary or his delegate, without regard to inter-company transactions in respect of which gain or loss was not recognized. For purposes of this section, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made by such corporation under chapter 6 of this subtitle (sec. 1501 and following) or under section 141 of the Internal Revenue Code of 1939 or of the Revenue Act of 1938, 1936, 1934, 1932, or 1928 shall be determined in accordance with regulations prescribed under section 1502 or in accordance with regulations prescribed under the appropriate section 141, as the case may be. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made by such corporation under chapter 6 of this subtitle or such section 141 shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 1502 or in accordance with regulations prescribed under the appropriate section 141, as the case may be.

SEC. 1052. BASIS ESTABLISHED BY THE REVENUE ACT OF 1932 OR 1934 OR BY THE INTERNAL REVENUE CODE OF 1939.

(a) REVENUE ACT OF 1932.—If the property was acquired, after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis thereof, for purposes of the Revenue Act of 1932 was prescribed by section 113 (a) (6), (7), or (9) of such Act (47 Stat. 199), then for purposes of this subtitle the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

(b) REVENUE ACT OF 1934.—If the property was acquired, after February 28, 1913, in any taxable year beginning before January 1, 1936, and the basis thereof, for purposes of the Revenue Act of 1934, was prescribed by section 113 (a) (6), (7), or (8) of such Act (48 Stat. 706), then for purposes of this subtitle the basis shall be the same as the basis therein prescribed in the Revenue Act of 1934.

(c) INTERNAL REVENUE CODE OF 1939.—If the property was acquired, after February 28, 1913, in a transaction to which the Internal Revenue Code of 1939 applied, and the basis thereof, for purposes of the Internal Revenue Code of 1939, was prescribed by section 113 (a) (6), (7), (8), (13), (15), (18), (19), or (23) of such code, then for purposes of this subtitle the basis shall be the same as the basis therein prescribed in the Internal Revenue Code of 1939.

SEC. 1053. PROPERTY ACQUIRED BEFORE MARCH 1, 1913.

In the case of property acquired before March 1, 1913, if the basis otherwise determined under this part, adjusted (for the period before March 1, 1913) as provided in section 1016, is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

SEC. 1054. CROSS REFERENCES.

(1) For nonrecognition of gain in connection with the transfer of obsolete vessels to the Maritime Administration under section 510 of the Merchant Marine Act, 1936, see subsection (e) of that section, as amended August 4, 1939 (46 U. S. C. 1160).

(2) For recognition of gain or loss in connection with the construction of new vessels, see section 511 of such Act, as amended (46 U. S. C. 1161).

(3) For nonrecognition of gain in connection with vessels exchanged with the Maritime Administration under section 8 of the Merchant Ship Sales Act of 1946, see subsection (a) of that section (50 U. S. C. App. 1741).

PART V—CHANGES TO EFFECTUATE F. C. C. POLICY

Sec. 1071. Gain from sale or exchange to effectuate policies of F. C. C.

SEC. 1071. GAIN FROM SALE OR EXCHANGE TO EFFECTUATE POLICIES OF F. C. C.

(a) NONRECOGNITION OF GAIN OR LOSS.—If the sale or exchange of property (including stock in a corporation) is certified by the Federal Communications Commission to be necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations, such sale or exchange shall, if the taxpayer so elects, be treated as an involuntary conversion of such property within the meaning of section 1033. For purposes of such section as made applicable by the provisions of this section, stock of a corporation operating a radio broadcasting station, whether or not representing control of such corporation, shall be treated as property similar or related in service or use to the property so converted. The part of the gain, if any, on such sale or exchange to which section 1033 is not applied shall nevertheless not be recognized, if the taxpayer so elects, to the extent that it is applied to reduce the basis for determining gain or loss on sale or exchange of property, of a character subject to the allowance for depreciation under section 167, remaining in the hands of the taxpayer immediately after the sale or exchange, or acquired in the same taxable year. The manner and amount of such reduction shall be determined under regulations prescribed by the Secretary or his delegate. Any election made by the

taxpayer under this section shall be made by a statement to that effect in his return for the taxable year in which the sale or exchange takes place, and such election shall be binding for the taxable year and all subsequent taxable years.

(b) BASIS.—

For basis of property acquired on a sale or exchange treated as an involuntary conversion under subsection (a), see section 1033 (c).

PART VI—EXCHANGES IN OBEDIENCE TO S. E. C. ORDERS

Sec. 1081. Nonrecognition of gain or loss on exchanges or distributions in obedience to orders of S. E. C.
Sec. 1082. Basis for determining gain or loss.
Sec. 1083. Definitions.

SEC. 1081. NONRECOGNITION OF GAIN OR LOSS ON EXCHANGES OR DISTRIBUTIONS IN OBEDIENCE TO ORDERS OF S. E. C.

(a) EXCHANGES OF STOCK OR SECURITIES ONLY.—No gain or loss shall be recognized to the transferor if stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are transferred to such corporation or to an associate company thereof which is a registered holding company or a majority-owned subsidiary company solely in exchange for stock or securities (other than stock or securities which are nonexempt property), and the exchange is made by the transferee corporation in obedience to an order of the Securities and Exchange Commission.

(b) EXCHANGES AND SALES OF PROPERTY BY CORPORATIONS.—

(1) GENERAL RULE.—No gain shall be recognized to a transferor corporation which is a registered holding company or an associate company of a registered holding company, if such corporation, in obedience to an order of the Securities and Exchange Commission, transfers property in exchange for property, and such order recites that such exchange by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member. Any gain, to the extent that it cannot be applied in reduction of basis under section 1082 (a) (2), shall be recognized.

(2) NONEXEMPT PROPERTY.—If any such property so received is nonexempt property, gain shall be recognized unless such nonexempt property or an amount equal to the fair market value of such property at the time of the transfer is, within 24 months of the transfer, under regulations prescribed by the Secretary or his delegate, and in accordance with an order of the Securities and Exchange Commission, expended for property other than nonexempt property or is invested as a contribution to the capital, or as paid-in surplus, of another corporation, and such order recites that such expenditure or investment by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member. If the fair market value of such nonexempt property at the time of the transfer exceeds the amount expended and the amount invested, as required in the preceding sentence, the gain, if any, to the extent of such excess, shall be recognized.

(3) CANCELLATION OR REDEMPTION OF STOCK OR SECURITIES.—For purposes of this subsection, a distribution in cancellation or

redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer) and a payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer shall be considered an expenditure for property other than nonexempt property, and if, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability shall be considered to be an expenditure by the transferor for property other than nonexempt property.

(4) CONSENTS.—This subsection shall not apply unless the transferor corporation consents, at such time and in such manner as the Secretary or his delegate may by regulations prescribe to the regulations prescribed under section 1082 (a) (2) in effect at the time of filing its return for the taxable year in which the transfer occurs.

(c) DISTRIBUTION OF STOCK OR SECURITIES ONLY.—

(1) IN GENERAL.—If there is distributed, in obedience to an order of the Securities and Exchange Commission, to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), without the surrender by such shareholder of stock or securities in such corporation, no gain to the distributee from the receipt of the stock or securities so distributed shall be recognized.

(2) SPECIAL RULE.—If—

(A) there is distributed to a shareholder in a corporation rights to acquire common stock in a second corporation without the surrender by such shareholder of stock in the first corporation,

(B) such distribution is in accordance with an arrangement forming a ground for an order of the Securities and Exchange Commission issued pursuant to section 3 of the Public Utility Holding Company Act of 1935 (49 Stat. 810; 15 U. S. C. 79c) that such corporation is exempt from any provision or provisions of such Act, and

(C) before January 1, 1958, the first corporation disposes of all of the common stock in the second corporation which it owns,

then no gain to the distributee from the receipt of the rights so distributed shall be recognized. If the first corporation does not, before January 1, 1958, dispose of all of the common stock which it owns in the second corporation, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment or the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting solely from the receipt of such rights to acquire stock, include one year immediately following the date on which the first corporation notifies the Secretary or his delegate whether or not the requirements of subparagraph (C) of the preceding sentence have been met; and such assessment and collection may be made notwithstanding any provision of law or rule of law which would otherwise prevent such assessment and collection.

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(d) TRANSFERS WITHIN SYSTEM GROUP.—

(1) GENERAL RULE.—No gain or loss shall be recognized to a corporation which is a member of a system group—

(A) if such corporation transfers property to another corporation which is a member of the same system group in exchange for other property, and the exchange by each corporation is made in obedience to an order of the Securities and Exchange Commission, or

(B) if there is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, property, without the surrender by such shareholder of stock or securities in the corporation making the distribution, and the distribution is made and received in obedience to an order of the Securities and Exchange Commission.

If an exchange by or a distribution to a corporation with respect to which no gain or loss is recognized under any of the provisions of this paragraph may also be considered to be within the provisions of subsection (a), (b), or (c), then the provisions of this paragraph only shall apply.

(2) SALES OF STOCK OR SECURITIES.—If the property received on an exchange which is within any of the provisions of paragraph (1) consists in whole or in part of stock or securities issued by the corporation from which such property was received, and if in obedience to an order of the Securities and Exchange Commission such stock or securities (other than stock which is not preferred as to both dividends and assets) are sold and the proceeds derived therefrom are applied in whole or in part in the retirement or cancellation of stock or of securities of the recipient corporation outstanding at the time of such exchange, no gain or loss shall be recognized to the recipient corporation on the sale of the stock or securities with respect to which such order was made; except that if any part of the proceeds derived from the sale of such stock or securities is not so applied, or if the amount of such proceeds is in excess of the fair market value of such stock or securities at the time of such exchange, the gain, if any, shall be recognized, but in an amount not in excess of the proceeds which are not so applied, or in an amount not more than the amount by which the proceeds derived from such sale exceed such fair market value, whichever is the greater.

(e) EXCHANGES NOT SOLELY IN KIND.—

(1) GENERAL RULE.—If an exchange (not within any of the provisions of subsection (d)) would be within the provisions of subsection (a) if it were not for the fact that property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain or loss, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property, and the loss, if any, to the recipient shall not be recognized.

(2) DISTRIBUTION TREATED AS DIVIDEND.—If an exchange is within the provisions of paragraph (1) and if it includes a distribution which has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an

amount of the gain recognized under such paragraph as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(f) CONDITIONS FOR APPLICATION OF SECTION.—Except in the case of a distribution described in subsection (c) (2), the provisions of this section shall not apply to an exchange, expenditure, investment, distribution, or sale unless—

(1) the order of the Securities and Exchange Commission in obedience to which such exchange, expenditure, investment, distribution, or sale was made recites that such exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (49 Stat. 820; 15 U. S. C. 79k (b)),

(2) such order specifies and itemizes the stock and securities and other property which are ordered to be acquired, transferred, received, or sold on such exchange, acquisition, expenditure, distribution, or sale, and, in the case of an investment, the investment to be made, and

(3) such exchange, acquisition, expenditure, investment, distribution, or sale was made in obedience to such order, and was completed within the time prescribed therefor.

(g) NONAPPLICATION OF OTHER PROVISIONS.—If a distribution described in subsection (c) (2), or an exchange or distribution made in obedience to an order of the Securities and Exchange Commission, is within any of the provisions of this part and may also be considered to be within any of the other provisions of this subchapter or subchapter C (sec. 301 and following, relating to corporate distributions and adjustments), then the provisions of this part only shall apply.

SEC. 1082. BASIS FOR DETERMINING GAIN OR LOSS.

(a) EXCHANGES GENERALLY.—

(1) EXCHANGES SUBJECT TO THE PROVISIONS OF SECTION 1081 (a) OR (e).—If the property was acquired on an exchange subject to the provisions of section 1081 (a) or (e), or the corresponding provisions of prior internal revenue laws, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer, and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 1081 (a) to be received without the recognition of gain or loss, and in part of nonexempt property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange. This subsection shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

(2) EXCHANGES SUBJECT TO THE PROVISIONS OF SECTION 1081 (b).—The gain not recognized on a transfer by reason of section 1081 (b)

or the corresponding provisions of prior internal revenue laws shall be applied to reduce the basis for determining gain or loss on sale or exchange of the following categories of property in the hands of the transferor immediately after the transfer, and property acquired within 24 months after such transfer by an expenditure or investment to which section 1081 (b) relates on account of the acquisition of which gain is not recognized under such subsection, in the following order:

(A) property of a character subject to the allowance for depreciation under section 167;

(B) property (not described in subparagraph (A)) with respect to which a deduction for amortization is allowable under section 168 or 169;

(C) property with respect to which a deduction for depletion is allowable under section 611 but not allowable under section 613;

(D) stock and securities of corporations not members of the system group of which the transferor is a member (other than stock or securities of a corporation of which the transferor is a subsidiary);

(E) securities (other than stock) of corporations which are members of the system group of which the transferor is a member (other than securities of the transferor or of a corporation of which the transferor is a subsidiary);

(F) stock of corporations which are members of the system group of which the transferor is a member (other than stock of the transferor or of a corporation of which the transferor is a subsidiary);

(G) all other remaining property of the transferor (other than stock or securities of the transferor or of a corporation of which the transferor is a subsidiary).

The manner and amount of the reduction to be applied to particular property within any of the categories described in subparagraphs (A) to (G), inclusive, shall be determined under regulations prescribed by the Secretary or his delegate.

(3) BASIS IN CASE OF PRE-1942 ACQUISITION.—Notwithstanding the provisions of paragraph (1) or (2), if the property was acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 of the Internal Revenue Code of 1939 before its amendment by the Revenue Act of 1942, the basis shall be that prescribed in such section (before its amendment by such Act) with respect to such property.

(b) TRANSFERS TO CORPORATIONS.—If, in connection with a transfer subject to the provisions of section 1081 (a), (b), or (e) or the corresponding provisions of prior internal revenue laws, the property was acquired by a corporation, either as paid-in surplus or as a contribution to capital, or in consideration for stock or securities issued by the corporation receiving the property (including cases where part of the consideration for the transfer of such property to the corporation consisted of property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor on such transfer under the law applicable to the year in which the transfer was made.

(c) DISTRIBUTIONS OF STOCK OR SECURITIES.—If the stock or securities were received in a distribution subject to the provisions of section 1081 (c) or the corresponding provisions of prior internal revenue laws, then the basis in the case of the stock in respect of which the distribution was made shall be apportioned, under regulations prescribed by the Secretary or his delegate, between such stock and the stock or securities distributed.

(d) TRANSFERS WITHIN SYSTEM GROUP.—If the property was acquired by a corporation which is a member of a system group on a transfer or distribution described in section 1081 (d) (1), then the basis shall be the same as it would be in the hands of the transferor; except that if such property is stock or securities issued by the corporation from which such stock or securities were received and they were issued—

(1) as the sole consideration for the property transferred to such corporation, then the basis of such stock or securities shall be either—

(A) the same as in the case of the property transferred therefor, or

(B) the fair market value of such stock or securities at the time of their receipt, whichever is the lower; or

(2) as part consideration for the property transferred to such corporation, then the basis of such stock or securities shall be either—

(A) an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities at the time of their receipt bears to the total fair market value of the entire consideration received, or

(B) the fair market value of such stock or securities at the time of their receipt, whichever is the lower.

SEC. 1083. DEFINITIONS

(a) ORDER OF SECURITIES AND EXCHANGE COMMISSION.—For purposes of this part, the term "order of the Securities and Exchange Commission" means an order issued after May 28, 1938, by the Securities and Exchange Commission which requires, authorizes, permits, or approves transactions described in such order to effectuate section 11 (b) of the Public Utility Holding Company Act of 1935 (49 Stat. 820; 15 U. S. C. 79k (b)), which has become or becomes final in accordance with law.

(b) REGISTERED HOLDING COMPANY; HOLDING COMPANY SYSTEM; ASSOCIATE COMPANY.—For purposes of this part, the terms "registered holding company", "holding company system", and "associate company" shall have the meanings assigned to them by section 2 of the Public Utility Holding Company Act of 1935 (49 Stat. 804; 15 U. S. C. 79b (a)).

(c) MAJORITY-OWNED SUBSIDIARY COMPANY.—For purposes of this part, the term "majority-owned subsidiary company" of a registered holding company means a corporation, stock of which, representing in the aggregate more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote (not including stock which is entitled to vote only on default or nonpayment of dividends or other special circumstances) is owned wholly by such registered holding company, or partly by such registered holding company and partly by one or more majority-owned subsidiary

companies thereof, or by one or more majority-owned subsidiary companies of such registered holding company.

(d) SYSTEM GROUP.—For purposes of this part, the term "system group" means one or more chains of corporations connected through stock ownership with a common parent corporation if—

(1) at least 90 percent of each class of the stock (other than (A) stock which is preferred as to both dividends and assets, and (B) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 percent of the aggregate value of all classes of stock which are not preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) the common parent corporation owns directly at least 90 percent of each class of the stock (other than stock, which is preferred as to both dividends and assets) of at least one of the other corporations; and

(3) each of the corporations is either a registered holding company or a majority-owned subsidiary company.

(e) NONEXEMPT PROPERTY.—For purposes of this part, the term "nonexempt property" means—

(1) any consideration in the form of evidences of indebtedness owed by the transferor or a cancellation or assumption of debts or other liabilities of the transferor (including a continuance of encumbrances subject to which the property was transferred);

(2) short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace;

(3) securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof);

(4) stock or securities which were acquired from a registered holding company or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities (other than obligations described as nonexempt property in paragraph (1), (2), or (3)) were acquired in obedience to an order of the Securities and Exchange Commission or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935 (49 Stat. 820; 15 U. S. C. 79k (b));

(5) money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in paragraph (2) or (3).

(f) STOCK OR SECURITIES.—For purposes of this part, the term "stock or securities" means shares of stock in any corporation, certificates of stock or interest in any corporation, notes, bonds, debentures, and evidences of indebtedness (including any evidence of an interest in or right to subscribe to or purchase any of the foregoing).

PART VII—WASH SALES OF STOCK OR SECURITIES

Sec. 1091. Loss from wash sales of stock or securities.

SEC. 1091. LOSS FROM WASH SALES OF STOCK OR SECURITIES.

(a) DISALLOWANCE OF LOSS DEDUCTION.—In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction for the loss shall be allowed under section 165 (c) (2); nor shall such deduction be allowed a corporation under section 165 (a) unless it is a dealer in stocks or securities, and the loss is sustained in a transaction made in the ordinary course of its business.

(b) STOCK ACQUIRED LESS THAN STOCK SOLD.—If the amount of stock or securities acquired (or covered by the contract or option to acquire) is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be determined under regulations prescribed by the Secretary or his delegate.

(c) STOCK ACQUIRED NOT LESS THAN STOCK SOLD.—If the amount of stock or securities acquired (or covered by the contract or option to acquire) is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility of the loss shall be determined under regulations prescribed by the Secretary or his delegate.

(d) UNADJUSTED BASIS IN CASE OF WASH SALE OF STOCK.—If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under this section or corresponding provisions of prior internal revenue laws) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.

Subchapter P—Capital Gains and Losses

Part I. Treatment of capital gains.
Part II. Treatment of capital losses.
Part III. General rules for determining capital gains and losses.
Part IV. Special rules for determining capital gains and losses.

PART I—TREATMENT OF CAPITAL GAINS

Sec. 1201. Alternative tax.
Sec. 1202. Deduction for capital gains.

SEC. 1201. ALTERNATIVE TAX.

(a) CORPORATIONS.—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 11, 511, 821 (a) (1) or (b), and 831 (a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess.

In the case of a taxable year beginning before April 1, 1954, the amount under paragraph (2) shall be determined without regard to section 21 (relating to effect of change of tax rates).

(b) OTHER TAXPAYERS.—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

SEC. 1202. DEDUCTION FOR CAPITAL GAINS.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

PART II—TREATMENT OF CAPITAL LOSSES

Sec. 1211. Limitation on capital losses.
Sec. 1212. Capital loss carryover.

SEC. 1211. LIMITATION ON CAPITAL LOSSES.

(a) CORPORATIONS.—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

(b) OTHER TAXPAYERS.—In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or $1,000, whichever is smaller. For purposes of this subsection, taxable income shall be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. If the taxpayer elects to pay the optional tax imposed by section 3, "taxable income" as used in this subsection shall be read as "adjusted gross income".

SEC. 1212. CAPITAL LOSS CARRYOVER.

If for any taxable year the taxpayer 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 that 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. For purposes of this section, a net capital gain shall be computed without regard to such net capital loss or to any net capital losses arising in any such intervening taxable years, and a net capital loss for a taxable year beginning before October 20, 1951, shall be determined under the applicable law relating to the computation of capital gains and losses in effect before such date.

PART III—GENERAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

Sec. 1221. Capital asset defined.
Sec. 1222. Other items relating to capital gains and losses.
Sec. 1223. Holding period of property.

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle—

(1) SHORT-TERM CAPITAL GAIN.—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income.

(2) SHORT-TERM CAPITAL LOSS.—The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent that such loss is taken into account in computing taxable income.

(3) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

(4) LONG-TERM CAPITAL LOSS.—The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 6 months, if and to the extent that such loss is taken into account in computing taxable income.

(5) NET SHORT-TERM CAPITAL GAIN.—The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.

(6) NET SHORT-TERM CAPITAL LOSS.—The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

(7) NET LONG-TERM CAPITAL GAIN.—The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.

(8) NET LONG-TERM CAPITAL LOSS.—The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

(9) NET CAPITAL GAIN.—

(A) CORPORATIONS.—In the case of a corporation, the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.

(B) OTHER TAXPAYERS.—In the case of a taxpayer other than a corporation, the term "net capital gain" means the excess of—

(i) the sum of the gains from sales or exchanges of capital assets, plus taxable income (computed without regard to the deductions provided by section 151, relating to personal exemptions or any deduction in lieu thereof) of the taxpayer or $1,000, whichever is smaller, over

(ii) the losses from such sales or exchanges.

For purposes of this subparagraph, taxable income shall be computed without regard to gains or losses from sales or exchanges of capital assets. If the taxpayer elects to pay the optional tax under section 3, the term "taxable income" as used in this subparagraph shall be read as "adjusted gross income."

(10) NET CAPITAL LOSS.—The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 1211. For the purpose of determining losses under this paragraph, amounts which are short-term capital losses under section 1212 shall be excluded.

SEC. 1223. HOLDING PERIOD OF PROPERTY.

For purposes of this subtitle—

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231. For purposes of this paragraph—

(A) an involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired, and

(B) a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under section 1081 (c) (or under section 112 (g) of the Revenue Act of 1928, 45 Stat. 818, or the Revenue Act of 1932, 48 Stat. 705), there shall be included the period for which he held the stock or securities in the distributing corporation before the receipt of the stock or securities on such distribution.

(4) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option

to acquire which) resulted in the nondeductibility (under section 1091 relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.

(5) In determining the period for which the taxpayer has held stock or rights to acquire stock received on a distribution, if the basis of such stock or rights is determined under section 307 (or under so much of section 1052 (c) as refers to section 113 (a) (23) of the Internal Revenue Code of 1939), there shall (under regulations prescribed by the Secretary or his delegate) be included the period for which he held the stock in the distributing corporation before the receipt of such stock or rights upon such distribution.

(6) In determining the period for which the taxpayer has held stock or securities acquired from a corporation by the exercise of rights to acquire such stock or securities, there shall be included only the period beginning with the date on which the right to acquire was exercised.

(7) In determining the period for which the taxpayer has held a residence, the acquisition of which resulted under section 1034 in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, there shall be included the period for which such other residence had been held as of the date of such sale or exchange. For purposes of this paragraph, the term "sale or exchange" includes an involuntary conversion occurring after December 31, 1950, and before January 1, 1954.

(8) In determining the period for which the taxpayer has held a commodity acquired in satisfaction of a commodity futures contract there shall be included the period for which he held the commodity futures contract if such commodity futures contract was a capital asset in his hands.

(9) Any reference in this section to a provision of this title shall, where applicable, be deemed a reference to the corresponding provision of the Internal Revenue Code of 1939, or prior internal revenue laws.

(10) CROSS REFERENCE.—

For special holding period provision relating to certain partnership distributions, see section 735 (b).

PART IV—SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

Sec. 1231. Property used in the trade or business and involuntary conversions.
Sec. 1232. Bonds and other evidences of indebtedness.
Sec. 1233. Gains and losses from short sales.
Sec. 1234. Options to buy or sell.
Sec. 1235. Sale or exchange of patents.
Sec. 1236. Dealers in securities.
Sec. 1237. Real property subdivided for sale.
Sec. 1238. Amortization in excess of depreciation.
Sec. 1239. Gain from sale of certain property between spouses or between an individual and a controlled corporation.
Sec. 1240. Taxability to employee of termination payments.
Sec. 1241. Cancellation of lease or distributor's agreement.

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) GENERAL RULE.—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection—

(1) in determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply; and

(2) losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

(b) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS.—For purposes of this section—

(1) GENERAL RULE.—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(2) TIMBER OR COAL.—Such term includes timber and coal with respect to which section 631 applies.

(3) LIVESTOCK.—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(4) UNHARVESTED CROP.—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) GENERAL RULE.—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) RETIREMENT.—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) SALE OR EXCHANGE.—

(A) GENERAL RULE.—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidences of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity, shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

(B) EXCEPTIONS.—This paragraph shall not apply to—

(i) obligations the interest on which is not includible in gross income under section 103 (relating to certain governmental obligations), or

(ii) any holder who has purchased the bond or other evidence of indebtedness at a premium.

(C) ELECTION AS TO INCLUSION.—In the case of obligations with respect to which the taxpayer has made an election provided by section 454 (a) and (c) (relating to accounting rules for certain obligations issued at a discount), this section shall not require the inclusion of any amount previously includible in gross income.

(b) DEFINITIONS.—

(1) ORIGINAL ISSUE DISCOUNT.—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) ISSUE PRICE.—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond. For purposes of this paragraph, the terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof.

(3) ISSUE DATE.—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "date of original issue" means the date on which the issue was first sold to the public at the issue price. In the case of privately placed issues of bonds or other evidences of indebtedness, the term "date of original issue" means the date on which each such bond or other evidence of indebtedness was sold by the issuer.

(c) BOND WITH EXCESS NUMBER OF COUPONS DETACHED.—If—

(1) a bond or other evidence of indebtedness issued at any time with interest coupons is purchased after the date of enactment of this title, and

(2) the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, then the gain on the sale or other disposition of such evidence of indebtedness by such purchaser shall be considered as gain from the sale or exchange of property which is not a capital asset to the extent that the market value (determined as of the time of the purchase) of the evidence of indebtedness with coupons attached exceeds the purchase price. If this subsection and subsection (a) (2) (A) apply with respect to gain realized on the retirement of any bond, then subsection (a) (2) (A) shall apply with respect to that part of the gain to which this subsection does not apply.

(d) CROSS REFERENCE.—

For special treatment of face-amount certificates on retirement, see section 72.

SEC. 1233. GAINS AND LOSSES FROM SHORT SALES.

(a) CAPITAL ASSETS.-For purposes of this subtitle, gain or loss from the short sale of property, other than a hedging transaction in commodity futures, shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property,

including a commodity future, used to close the short sale constitutes a capital asset in the hands of the taxpayer.

(b) SHORT-TERM GAINS AND HOLDING PERIODS.—If gain or loss from a short sale is considered as gain or loss from the sale or exchange of a capital asset under subsection (a) and if on the date of such short sale substantially identical property has been held by the taxpayer for not more than 6 months (determined without regard to the effect, under paragraph (2) of this subsection, of such short sale on the holding period), or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof—

(1) any gain on the closing of such short sale shall be considered as a gain on the sale or exchange of a capital asset held for not more than 6 months (notwithstanding the period of time any property used to close such short sale has been held); and

(2) the holding period of such substantially identical property shall be considered to begin (notwithstanding section 1223, relating to the holding period of property) on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of such property, whichever date occurs first. This paragraph shall apply to such substantially identical property in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short.

For purposes of this subsection, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale.

(c) CERTAIN OPTIONS TO SELL.—Subsection (b) shall not include an option to sell property at a fixed price acquired on the same day on which the property identified as intended to be used in exercising such option is acquired and which, if exercised, is exercised through the sale of the property so identified. If the option is not exercised, the cost of the option shall be added to the basis of the property with which the option is identified. This subsection shall apply only to options acquired after the date of enactment of this title.

(d) LONG-TERM LOSSES.—If on the date of such short sale substantially identical property has been held by the taxpayer for more than 6 months, any loss on the closing of such short sale shall be considered as a loss on the sale or exchange of a capital asset held for more than 6 months (notwithstanding the period of time any property used to close such short sale has been held, and notwithstanding section 1234).

(e) RULES FOR APPLICATION OF SECTION—

(1) Subsection (b) (1) or (d) shall not apply to the gain or loss, respectively, on any quantity of property used to close such short sale which is in excess of the quantity of the substantially identical property referred to in the applicable subsection.

(2) For purposes of subsections (b) and (d)—

(A) the term "property" includes only stocks and securities (including stocks and securities dealt with on a "when issued" basis), and commodity futures, which are capital assets in the hands of the taxpayer;

(B) in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in 1 calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month; and

(C) in the case of a short sale of property by an individual, the term "taxpayer", in the application of this subsection and subsections (b) and (d), shall be read as "taxpayer or his spouse"; but an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

(3) Where the taxpayer enters into 2 commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, subsections (b) and (d) shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other.

SEC. 1234. OPTIONS TO BUY OR SELL.

Gain or loss attributable to the sale or exchange of, or loss on failure to exercise, a privilege or option to buy or sell property which in the hands of the taxpayer constitutes (or if acquired would constitute) a capital asset shall be considered gain or loss from the sale or exchange of a capital asset; and, if the loss is attributable to failure to exercise such privilege or option, the privilege or option shall be deemed to have been sold or exchanged on the day it expired. This section shall not apply to losses on failure to exercise options described in section 1233 (c).

SEC. 1235. SALE OR EXCHANGE OF PATENTS.

(a) GENERAL.—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which 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, regardless of whether or not payments in consideration of such transfer are—

(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) contingent on the productivity, use, or disposition of the property transferred.

(b) "HOLDER" DEFINED.—For purposes of this section, the term "holder" means—

(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)).

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(c) EFFECTIVE DATE.—This section shall be applicable with regard to any amounts received, or payments made, pursuant to a transfer described in subsection (a) in any taxable year to which this subtitle applies, regardless of the taxable year in which such transfer occurred.

(d) RELATED PERSONS.—Subsection (a) shall not apply to any sale or exchange between an individual and any other related person (as defined in section 267 (b)), except brothers and sisters, whether by the whole or half blood.

(e) CROSS REFERENCE.—

For special rule relating to nonresident aliens, see section 871 (a).

SEC. 1236. DEALERS IN SECURITIES.

(a) CAPITAL GAINS.—Gain 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—

(1) the security was, before the expiration of the 30th day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment or if acquired before October 20, 1951, was so identified before November 20, 1951; and

(2) the security was not, at any time after the expiration of such 30th day, held by such dealer primarily for sale to customers in the ordinary course of his trade or business.

(b) ORDINARY LOSSES.—Loss by a dealer in securities from the sale or exchange of any security shall, except as otherwise provided in section 582 (c), (relating to bond, etc., losses of banks), in no event be considered as loss from the sale or exchange of property which is not a capital asset if at any time after November 19, 1951, the security was clearly identified in the dealer's records as a security held for investment.

(c) DEFINITION OF SECURITY.—For purposes of this section, 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.

SEC. 1237. REAL PROPERTY SUBDIVIDED FOR SALE.

(a) GENERAL.—Any lot or parcel which is part of a tract of real property in the hands of a taxpayer other than a corporation shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale, if—

(1) such tract, or any lot or parcel thereof, had not previously been held by such taxpayer primarily for sale to customers in the ordinary course of trade or business (unless such tract at such previous time would have been covered by this section) or, in the same taxable year in which the sale occurs, such taxpayer does not so hold any other real property; and

(2) no substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer. For purposes of this paragraph, an improvement shall be deemed to be made by the taxpayer if such improvement was made by—

(A) the taxpayer or members of his family (as defined in section 267 (c) (4)), by a corporation controlled by the taxpayer, or by a partnership which included the taxpayer as a partner; or

(B) a lessee, but only if the improvement constitutes income to the taxpayer; or

(C) Federal, State, or local government, or political subdivision thereof, but only if the improvement constitutes an addition to basis for the taxpayer; and

(3) such lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of 5 years.

(b) SPECIAL RULES FOR APPLICATION OF SECTION.—

(1) GAINS.—If more than 5 lots or parcels contained in the same tract of real property are sold or exchanged, gain from any sale or exchange (which occurs in or after the taxable year in which the sixth lot or parcel is sold or exchanged) of any lot or parcel which comes within the provisions of paragraphs (1), (2) and (3) of subsection (a) of this section shall be deemed to be gain from the sale of property held primarily for sale to customers in the ordinary course of the trade or business to the extent of 5 percent of the selling price.

(2) EXPENDITURES OF SALE.—For the purpose of computing gain under paragraph (1) of this subsection, expenditures incurred in connection with the sale or exchange of any lot or parcel shall neither be allowed as a deduction in computing taxable income, nor treated as reducing the amount realized on such sale or exchange; but so much of such expenditures as does not exceed the portion of gain deemed under paragraph (1) of this subsection to be gain from the sale of property held primarily for sale to customers in the ordinary course of trade or business shall be so allowed as a deduction, and the remainder, if any, shall be treated as reducing the amount realized on such sale or exchange.

(3) NECESSARY IMPROVEMENTS.—No improvement shall be deemed a substantial improvement for purposes of subsection (a) if the lot or parcel is held by the taxpayer for a period of 10 years and if—

(A) such improvement is the building or installation of water or sewer facilities or roads (if such improvement would except for this paragraph constitute a substantial improvement);

(B) it is shown to the satisfaction of the Secretary or his delegate that the lot or parcel, the value of which was substantially enhanced by such improvement, would not have been marketable at the prevailing local price for similar building sites without such improvement; and

(C) the taxpayer elects, in accordance with regulations prescribed by the Secretary or his delegate, to make no adjustment to basis of the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures for such improvements. Such election shall not make any item deductible which would not otherwise be deductible.

(c) TRACT DEFINED.—For purposes of this section, the term "tract of real property" means a single piece of real property, except that 2 or more pieces of real property shall be considered a tract if at any

time they were contiguous in the hands of the taxpayer or if they would be contiguous except for the interposition of a road, street, railroad, stream, or similar property. If, following the sale or exchange of any lot or parcel from a tract of real property, no further sales or exchanges of any other lots or parcels from the remainder of such tract are made for a period of 5 years, such remainder shall be deemed a tract.

(d) EFFECTIVE DATE.—This section shall apply only with respect to sales of property occurring after December 31, 1953, except that, for purposes of subsection (c) (defining tract of real property) and for determining the number of sales under paragraph (1) of subsection (b), all sales of lots and parcels from any tract of real property during the period of 5 years before December 31, 1953, shall be taken into account, except as provided in subsection (c).

SEC. 1238. AMORTIZATION IN EXCESS OF DEPRECIATION.

Gain from the sale or exchange of property, to the extent that the adjusted basis of such property is less than its adjusted basis determined without regard to section 168 (relating to amortization deduction of emergency facilities), shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

SEC. 1239. GAIN FROM SALE OF CERTAIN PROPERTY BETWEEN SPOUSES OR BETWEEN AN INDIVIDUAL AND A CONTROLLED CORPORATION.

(a) TREATMENT OF GAIN AS ORDINARY INCOME.—In the case of a sale or exchange, directly or indirectly, of property described in subsection (b)—

(1) between a husband and wife; or

(2) between an individual and a corporation more than 80 percent in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and minor grandchildren;

any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(b) SECTION APPLICABLE ONLY TO SALES OR EXCHANGES OF DEPRECIABLE PROPERTY.—This section shall apply only in the case of a sale or exchange by a transferor of property which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 167.

SEC. 1240. TAXABILITY TO EMPLOYEE OF TERMINATION PAYMENTS.

Amounts received from the assignment or release by an employee, after more than 20 years' employment, of all his rights to receive, after termination of his employment and for a period of not less than 5 years (or for a period ending with his death), a percentage of future profits or receipts of his employer shall be considered an amount received from the sale or exchange of a capital asset held for more than 6 months if—

(1) such rights were included in the terms of the employment of such employee for not less than 12 years,

(2) such rights were included in the terms of the employment of such employee before the date of enactment of this title, and

(3) the total of the amounts received for such assignment or release is received in one taxable year and after the termination of such employment.

SEC. 1241. CANCELLATION OF LEASE OR DISTRIBUTOR'S AGREEMENT.

Amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), shall be considered as amounts received in exchange for such lease or agreement.

Subchapter Q—Readjustment of Tax Between Years and Special Limitations

Part I. Income attributable to several taxable years.
Part II. Mitigation of effect of limitations and other provisions.
Part III. Involuntary liquidation and replacement of LIFO inventories.
Part IV. War loss recoveries.
Part V. Claim of right.
Part VI. Other limitations.

PART I—INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

Sec. 1301. Compensation from an employment.
Sec. 1302. Income from an invention or artistic work.
Sec. 1303. Income from back pay.
Sec. 1304. Rules applicable to this part.

SEC. 1301. COMPENSATION FROM AN EMPLOYMENT.

(a) LIMITATION ON TAX.—If an individual or partnership—

(1) engages in an employment as defined in subsection (b); and

(2) the employment covers a period of 36 months or more (from the beginning to the completion of such employment); and

(3) the gross compensation from the employment received or accrued in the taxable year of the individual or partnership is not less than 80 percent of the total compensation from such employment,

then the tax attributable to any part of the compensation which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual.

(b) DEFINITION OF AN EMPLOYMENT.—For purposes of this section, the term "an employment" means an arrangement or series of arrangements for the performance of personal services by an individual or partnership to effect a particular result, regardless of the number of sources from which compensation therefor is obtained.

(c) RULE WITH RESPECT TO PARTNERS.—An individual who is a member of a partnership receiving or accruing compensation from an employment of the type described in subsection (a) shall be entitled to the benefits of that subsection only if the individual has been a member of the partnership continuously for a period of 36 months or the period of the employment immediately preceding the receipt or accrual. In such a case the tax attributable to the part of the compensation which is includible in the gross income of the individual shall not be greater than the aggregate of the taxes which would have been attributable to that part had it been included in the gross income of the individual ratably over the period in which it was earned or the period during which the individual continuously was a member of the partnership, whichever period is the shorter. For purposes of

this subsection, a member of a partnership shall be deemed to have been a member of the partnership for any period, ending immediately prior to becoming such a member, in which he was an employee of such partnership, if during the taxable year he received or accrued compensation attributable to employment by the partnership during such period.

SEC. 1302. INCOME FROM AN INVENTION OR ARTISTIC WORK.

(a) LIMITATION ON TAX.—If—

(1) an individual includes in gross income amounts in respect of a particular invention or artistic work created by the individual; and

(2) the work on the invention or the artistic work covered a period of 24 months or more (from the beginning to the completion thereof); and

(3) the amounts in respect of the invention or the artistic work includible in gross income for the taxable year are not less than 80 percent of the gross income in respect of such invention or artistic work in the taxable year plus the gross income therefrom in previous taxable years and the 12 months immediately succeeding the close of the taxable year,

then the tax attributable to the part of such gross income of the taxable year which is not taxable as a gain from the sale or exchange of a capital asset held for more than 6 months shall not be greater than the aggregate of the taxes attributable to such part had it been received ratably over, in the case of an invention, that part of the period preceding the close of the taxable year or 60 months, whichever is shorter, or, in the case of an artistic work, that part of the period preceding the close of the taxable year but not more than 36 months.

(b) DEFINITIONS.—For purposes of this section—

(1) INVENTION.—The term "invention" means a patent covering an invention of the individual.

(2) ARTISTIC WORK.—The term "artistic work" means a literary, musical, or artistic composition or a copyright covering a literary, musical, or artistic composition.

SEC. 1303. INCOME FROM BACK PAY.

(a) LIMITATION ON TAX.—If the amount of the back pay received or accrued by an individual during the taxable year exceeds 15 percent of the gross income of the individual for such year, the part of the tax attributable to the inclusion of such back pay in gross income for the taxable year shall not be greater than the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for the taxable years to which such portions are respectively attributable, as determined under regulations prescribed by the Secretary or his delegate.

(b) DEFINITION OF BACK PAY.—For purposes of this section, the term "back pay" means amounts includible in gross income under this subtitle which are one of the following—

(1) Remuneration, including wages, salaries, retirement pay, and other similar compensation, which is received or accrued during the taxable year by an employee for services performed before the taxable year for his employer and which would have been paid before the taxable year except for the intervention of one of the following events:

(A) bankruptcy or receivership of the employer;

(B) dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings;

(C) if the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or

(D) any other event determined to be similar in nature under regulations prescribed by the Secretary or his delegate.

(2) Wages or salaries which are received or accrued during the taxable year by an employee for services performed before the taxable year for his employer and which constitute retroactive wage or salary increases ordered, recommended, or approved by any Federal or State agency, and made retroactive to any period before the taxable year.

(3) Payments which are received or accrued during the taxable year as the result of an alleged violation by an employer of any State or Federal law relating to labor standards or practices, and which are determined under regulations prescribed by the Secretary or his delegate to be attributable to a prior taxable year.

SEC. 1304. RULES APPLICABLE TO THIS PART.

(a) FRACTIONAL PARTS OF A MONTH.—For purposes of this part, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it should be considered as a month.

(b) TAX ON SELF-EMPLOYMENT INCOME.—This part shall be applied without regard to, and shall not affect, the tax imposed by chapter 2 relating to self-employment income.

(c) COMPUTATION OF TAX ATTRIBUTABLE TO INCOME ALLOCATED TO PRIOR PERIOD.—For the purpose of computing the tax attributable to the amount of an item of gross income allocable under this part to a particular taxable year, such amount shall be considered income only of the person who would be required to include the item of gross income in a separate return filed for the taxable year in which such item was received or accrued.

(d) EFFECTIVE DATE OF CERTAIN SUBSECTIONS.—Subsection (c) of section 1301 and subsection (c) of this section shall apply only to amounts received or accrued after March 1, 1954. Notwithstanding any other provision of this title, section 107 of the Internal Revenue Code of 1939 shall apply to amounts received or accrued as a partner on or before March 1, 1954, under this section and to the computation of tax on amounts received or accrued on or before March 1, 1954.

PART II—MITIGATION OF EFFECT OF LIMITATIONS AND OTHER PROVISIONS

Sec. 1311. Correction of error.
Sec. 1312. Circumstances of adjustment.
Sec. 1313. Definitions.
Sec. 1314. Amount and method of adjustment.
Sec. 1315. Effective date.

SEC. 1311. CORRECTION OF ERROR.

(a) GENERAL RULE.—If a determination (as defined in section 1313) is described in one or more of the paragraphs of section 1312 and, on the date of the determination, correction of the effect of the error referred to in the applicable paragraph of section 1312 is prevented by the operation of any law or rule of law, other than this part and other than section 7122 (relating to compromises), then the effect of the error shall be corrected by an adjustment made in the amount and in the manner specified in section 1314.

(b) CONDITIONS NECESSARY FOR ADJUSTMENT.—

(1) MAINTENANCE OF AN INCONSISTENT POSITION.—Except in cases described in paragraphs (3) (B) and (4) of section 1312, an adjustment shall be made under this part only if—

(A) in case the amount of the adjustment would be credited or refunded in the same manner as an overpayment under section 1314, there is adopted in the determination a position maintained by the Secretary or his delegate, or

(B) in case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under section 1314, there is adopted in the determination a position maintained by the taxpayer with respect to whom the determination is made,

and the position maintained by the Secretary or his delegate in the case described in subparagraph (A) or maintained by the taxpayer in the case described in subparagraph (B) is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be.

(2) CORRECTION NOT BARRED AT TIME OF ERRONEOUS ACTION.—

(A) DETERMINATION DESCRIBED IN SECTION 1312 (3) (B).—In the case of a determination described in section 1312 (3) (B) (relating to certain exclusions from income), adjustment shall be made under this part only if assessment of a deficiency for the taxable year in which the item is includible or against the related taxpayer was not barred, by any law or rule of law, at the time the Secretary or his delegate first maintained, in a notice of deficiency sent pursuant to section 6212 or before the Tax Court of the United States, that the item described in section 1312 (3) (B) should be included in the gross income of the taxpayer for the taxable year to which the determination relates.

(B) DETERMINATION DESCRIBED IN SECTION 1312 (4).—In the case of a determination described in section 1312 (4) (relating to disallowance of certain deductions and credits), adjustment shall be made under this part only if credit or refund of the overpayment attributable to the deduction or credit described in such section which should have been allowed to the taxpayer or related taxpayer was not barred, by any law or rule of law, at the time the taxpayer first maintained before the Secretary or his delegate or

before the Tax Court of the United States, in writing, that he was entitled to such deduction or credit for the taxable year to which the determination relates.

(3) EXISTENCE OF RELATIONSHIP.—In case the amount of the adjustment would be assessed and collected in the same manner as a deficiency (except for cases described in section 1312 (3) (B)), the adjustment shall not be made with respect to a related taxpayer unless he stands in such relationship to the taxpayer at the time the latter first maintains the inconsistent position in a return, claim for refund, or petition (or amended petition) to the Tax Court of the United States for the taxable year with respect to which the determination is made, or if such position is not so maintained, then at the time of the determination.

SEC. 1312. CIRCUMSTANCES OF ADJUSTMENT.

The circumstances under which the adjustment provided in section 1311 is authorized are as follows:

(1) DOUBLE INCLUSION OF AN ITEM OF GROSS INCOME.—The determination requires the inclusion in gross income of an item which was erroneously included in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer.

(2) DOUBLE ALLOWANCE OF A DEDUCTION OR CREDIT.—The determination allows a deduction or credit which was erroneously allowed to the taxpayer for another taxable year or to a related taxpayer.

(3) DOUBLE EXCLUSION OF AN ITEM OF GROSS INCOME.—

(A) ITEMS INCLUDED IN INCOME.—The determination requires the exclusion from gross income of an item included in a return filed by the taxpayer or with respect to which tax was paid and which was erroneously excluded or omitted from the gross income of the taxpayer for another taxable year, or from the gross income of a related taxpayer; or

(B) ITEMS NOT INCLUDED IN INCOME.—The determination requires the exclusion from gross income of an item not included in a return filed by the taxpayer and with respect to which the tax was not paid but which is includible in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer.

(4) DOUBLE DISALLOWANCE OF A DEDUCTION OR CREDIT.—The determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, or to a related taxpayer.

(5) CORRELATIVE DEDUCTIONS AND INCLUSIONS FOR TRUSTS OR ESTATES AND LEGATEES, BENEFICIARIES, OR HEIRS.—The determination allows or disallows any of the additional deductions allowable in computing the taxable income of estates or trusts, or requires or denies any of the inclusions in the computation of taxable income of beneficiaries, heirs, or legatees, specified in subparts A to E, inclusive (secs. 641 and following, relating to estates, trusts, and beneficiaries) of part I of subchapter J of this chapter, or corresponding provisions of prior internal revenue laws, and the correlative inclusion or deduction, as the case may be, has been erroneously excluded, omitted, or included, or disallowed, omitted, or allowed, as the case may be, in respect of the related taxpayer.

(6) BASIS OF PROPERTY AFTER ERRONEOUS TREATMENT OF A PRIOR TRANSACTION.—

(A) GENERAL RULE.—The determination determines the basis of property, and in respect of any transaction on which such basis depends, or in respect of any transaction which was erroneously treated as affecting such basis, there occurred, with respect to a taxpayer described in subparagraph (B) of this paragraph, any of the errors described in subparagraph (C) of this paragraph.

(B) TAXPAYERS WITH RESPECT TO WHOM THE ERRONEOUS TREATMENT OCCURRED.—The taxpayer with respect to whom the erroneous treatment occurred must be—

(i) the taxpayer with respect to whom the determination is made,

(ii) a taxpayer who acquired title to the property in the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, or

(iii) a taxpayer who had title to the property at the time of the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015 (a) (relating to the basis of property acquired by gift).

(C) PRIOR ERRONEOUS TREATMENT.—With respect to a taxpayer described in subparagraph (B) of this paragraph—

(i) there was an erroneous inclusion in, or omission from, gross income,

(ii) there was an erroneous recognition, or nonrecognition, of gain or loss, or

(iii) there was an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

SEC. 1313. DEFINITIONS.

(a) DETERMINATION.—For purposes of this part, the term "determination" means—

(1) a decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(2) a closing agreement made under section 7121;

(3) a final disposition by the Secretary or his delegate of a claim for refund. For purposes of this part, a claim for refund shall be deemed finally disposed of by the Secretary or his delegate—

(A) as to items with respect to which the claim was allowed, on the date of allowance of refund or credit or on the date of mailing notice of disallowance (by reason of offsetting items) of the claim for refund, and

(B) as to items with respect to which the claim was disallowed, in whole or in part, or as to items applied by the Secretary or his delegate in reduction of the refund or credit, on expiration of the time for instituting suit with respect thereto (unless suit is instituted before the expiration of such time); or

(4) under regulations prescribed by the Secretary or his delegate, an agreement for purposes of this part, signed by the Secretary or his delegate and by any person, relating to the liability of such person (or the person for whom he acts) in respect of a tax under this subtitle for any taxable period.

(b) TAXPAYER.—Notwithstanding section 7701 (a) (14), the term "taxpayer" means any person subject to a tax under the applicable revenue law.

(c) RELATED TAXPAYER.—For purposes of this part, the term "related taxpayer" means a taxpayer who, with the taxpayer with respect to whom a determination is made, stood, in the taxable year with respect to which the erroneous inclusion, exclusion, omission, allowance, or disallowance was made, in one of the following relationships:

(1) husband and wife,
(2) grantor and fiduciary,
(3) grantor and beneficiary,
(4) fiduciary and beneficiary, legatee, or heir,
(5) decedent and decedent's estate,
(6) partner, or
(7) member of an affiliated group of corporations (as defined in section 1504).

SEC. 1314. AMOUNT AND METHOD OF ADJUSTMENT.

(a) ASCERTAINMENT OF AMOUNT OF ADJUSTMENT.—In computing the amount of an adjustment under this part there shall first be ascertained the tax previously determined for the taxable year with respect to which the error was made. The amount of the tax previously determined shall be the excess of—

(1) the sum of—

(A) the amount shown as the tax by the taxpayer on his return (determined as provided in section 6211 (b) (1) and (3), relating to the definition of deficiency), if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) the amount of rebates, as defined in section 6211 (b) (2), made.

There shall then be ascertained the increase or decrease in tax previously determined which results solely from the correct treatment of the item which was the subject of the error (with due regard given to the effect of the item in the computation of gross income, taxable income, and other matters under this subtitle). A similar computation shall be made for any other taxable year affected, or treated as affected, by a net operating loss deduction (as defined in section 172) or by a capital loss carryover (as defined in section 1212), determined with reference to the taxable year with respect to which the error was made. The amount so ascertained (together with any amounts wrongfully collected as additions to the tax or interest, as a result of such error) for each taxable year shall be the amount of the adjustment for that taxable year.

(b) METHOD OF ADJUSTMENT.—The adjustment authorized in section 1311 (a) shall be made by assessing and collecting, or refunding or crediting, the amount thereof in the same manner as if it were a

deficiency determined by the Secretary or his delegate with respect to the taxpayer as to whom the error was made or an overpayment claimed by such taxpayer, as the case may be, for the taxable year or years with respect to which an amount is ascertained under subsection (a), and as if on the date of the determination one year remained before the expiration of the periods of limitation upon assessment or filing claim for refund for such taxable year or years. If, as a result of a determination described in section 1313 (a) (4), an adjustment has been made by the assessment and collection of a deficiency or the refund or credit of an overpayment, and subsequently such determination is altered or revoked, the amount of the adjustment ascertained under subsection (a) of this section shall be redetermined on the basis of such alteration or revocation and any overpayment or deficiency resulting from such redetermination shall be refunded or credited, or assessed and collected, as the case may be, as an adjustment under this part. In the case of an adjustment resulting from an increase or decrease in a net operating loss which is carried back to the year of adjustment, interest shall not be collected or paid for any period prior to the close of the taxable year in which the net operating loss arises.

(c) ADJUSTMENT UNAFFECTED BY OTHER ITEMS.—The amount to be assessed and collected in the same manner as a deficiency, or to be refunded or credited in the same manner as an overpayment, under this part, shall not be diminished by any credit or set-off based upon any item other than the one which was the subject of the adjustment. Other than in the case of an adjustment resulting from a determination under section 1313 (a) (4), the amount of the adjustment under this part, if paid, shall not be recovered by a claim or suit for refund or suit for erroneous refund based upon any item other than the one which was the subject of the adjustment.

(d) PERIODS FOR WHICH ADJUSTMENTS MAY BE MADE.—No adjustment shall be made under this part in respect of any taxable year beginning prior to January 1, 1932.

(e) TAXES IMPOSED BY SUBTITLE C.—This part shall not apply to any tax imposed by subtitle C (sec. 3101 and following relating to employment taxes).

SEC. 1315. EFFECTIVE DATE.

(a) IN GENERAL.—This part shall apply only to determinations (as defined in section 1313 (a)) made after the 90th day after the date of enactment of this title.

(b) TRANSITIONAL PROVISION.—Notwithstanding any other provision of this title, section 3801 of the Internal Revenue Code of 1939 shall apply to determinations (as defined in subsection (a) of such section) made on or before such 90th day as if this title had not been enacted.

PART III—INVOLUNTARY LIQUIDATION AND REPLACEMENT OF LIFO INVENTORIES

Sec. 1321. Involuntary liquidation of LIFO inventories.

SEC. 1321. INVOLUNTARY LIQUIDATION OF LIFO INVENTORIES.

(a) ADJUSTMENT OF TAXABLE INCOME AND RESULTING TAX.—If, for any taxable year ending after June 30, 1950, and before January 1, 1955, the closing inventory of a taxpayer inventorying goods under the method provided in section 22 (d) of the Internal Revenue Code of 1939 reflects a decrease from the opening inventory of such goods for such year, and if the taxpayer elects, at such time and in such manner and subject to such regulations as the Secretary or his delegate may prescribe, to have this section apply, and if it is established to the satisfaction of the Secretary or his delegate, in accordance with such regulations, that such decrease is attributable to the involuntary liquidation of such inventory as defined in section 22 (d) (6) (B) of the Internal Revenue Code of 1939 (as modified by subsection (b) of this section), and if the closing inventory of a subsequent taxable year, ending before January 1, 1956, reflects a replacement, in whole or in part, of the goods so previously liquidated, then the taxable income of the taxpayer otherwise determined for the year of such involuntary liquidation shall be increased by an amount equal to the excess, if any, of the aggregate cost of such goods reflected in the opening inventory of the year of involuntary liquidation over the aggregate replacement cost, or decreased by an amount equal to the excess, if any, of the aggregate replacement cost of such goods over the aggregate cost thereof reflected in the opening inventory of the year of the involuntary liquidation. The taxes imposed by this chapter (and by chapters 1 and 2 of the Internal Revenue Code of 1939) for the year of such liquidation, for preceding taxable years, and for all taxable years intervening between the year of liquidation and the year of replacement shall be redetermined, giving effect to such adjustments. Any increase in such taxes resulting from such adjustments shall be assessed and collected as a deficiency but without interest, and any overpayment so resulting shall be credited or refunded to the taxpayer without interest.

(b) DEFINITIONS.—For purposes of this section, the term "involuntary liquidation" shall have the meaning given to it in section 22 (d) (6) (B) of the Internal Revenue Code of 1939 and, in addition, it shall mean a failure, as referred to in that section, on the part of the taxpayer due, directly and exclusively, to disruption of normal trade relations between countries. For purposes of this section, the words "enemy" and "war", as used in such section 22 (d) (6) (B), shall be interpreted, pursuant to regulations prescribed by the Secretary or his delegate, in such a way as to apply to circumstances, occurrences and conditions, lacking a state of war, which are similar, by reason of a state of national preparedness, to those which would exist under a state of war.

(c) SPECIAL RULES.—Subparagraphs (C) and (E) of section 22 (d) (6) of the Internal Revenue Code of 1939, to the extent that they refer to any taxpayer subject to subparagraph (A) of such section or to the adjustments specified in or resulting from the effect of subparagraph (A) of such section, shall apply to a taxpayer subject to this section or to adjustments specified in or resulting from the effect of

this section as though they specifically referred to this section. If, for any taxable year ending after June 30, 1950, and before January 1, 1953, subparagraph (C) of such section 22 (d) (6) applies with respect to involuntary liquidations of goods of the same class subject to both subparagraph (A) of such section and to this section, the involuntary liquidations of such goods subject to this section shall be considered for the purpose of such subparagraph (C) as having occurred before the involuntary liquidations of such goods subject to subparagraph (A) of such section 22 (d) (6). For the purpose of this subsection, and with respect to the taxable years covered by this section, the reference in subparagraph (E) of such section 22 (d) (6) to section 734 (d) shall be taken as a reference to section 452 (d) of the Internal Revenue Code of 1939, and, with respect to any taxable year to which any provision of the Internal Revenue Code of 1939 may not be applicable, references in such subparagraph to such provision shall, where applicable, be deemed a reference to the corresponding provision of the Internal Revenue Code of 1954.

PART IV—WAR LOSS RECOVERIES

Sec. 1331. War loss recoveries.
Sec. 1332. Inclusion in gross income of war loss recoveries.
Sec. 1333. Tax adjustment measured by prior benefits.
Sec. 1334. Restoration of value of investments referable to destroyed or seized property.
Sec. 1335. Election by taxpayer for application of section 1333.
Sec. 1336. Basis of recovered property.
Sec. 1337. Applicable rules.

SEC. 1331. WAR LOSS RECOVERIES.

On the recovery in the taxable year of any money or property in respect of property considered under section 127 (a) of the Internal Revenue Code of 1939, as destroyed or seized, the amount of such recovery shall be included in gross income to the extent provided in section 1332, unless section 1333 applies to the taxable year pursuant to an election made by the taxpayer under section 1335.

SEC. 1332. INCLUSION IN GROSS INCOME OF WAR LOSS RECOVERIES.

(a) AMOUNT OF RECOVERY.—The amount of the recovery of any money or property in respect of property considered under section 127 (a) of the Internal Revenue Code of 1939, as destroyed or seized, shall be an amount equal to the aggregate of such money and the fair market value of such property, determined as of the date of the recovery.

(b) AMOUNT OF GAIN INCLUDIBLE.—

(1) PORTION EXCLUDED FROM GROSS INCOME.—To the extent that the amount of the recovery plus the aggregate of the amounts of previous such recoveries do not exceed that part of the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of property described in such section 127 (a) which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939, such amount shall not be includible in gross income and shall not be deemed gain on the involuntary conversion of property as a result of its destruction or seizure.

(2) PORTION TREATED AS ORDINARY INCOME.—To the extent that such amount plus the aggregate of the amounts of previous such recoveries exceed that part of the aggregate of such deductions, which did not result in a reduction of any tax of the taxpayer under such chapters and do not exceed that part of the aggregate of such deductions which did result in a reduction of any tax of the taxpayer under such chapters, such amount shall be included in gross income but shall not be deemed a gain on the involuntary conversion of property as a result of its destruction or seizure.

(3) PORTION TREATED AS GAIN ON INVOLUNTARY CONVERSION.—To the extent that such amount plus the aggregate of the amounts of previous such recoveries exceed the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of property described in such section 127 (a), such amount shall be considered a gain on the involuntary conversion of property as a result of its destruction or seizure and shall be recognized or not recognized as provided in section 1033 (relating to involuntary conversions).

(4) OBLIGATIONS NOT DISCHARGED.—If for any previous taxable year the taxpayer chose under section 127 (b) of the Internal Revenue Code of 1939 to treat any obligations and liabilities as discharged or satisfied out of the property or interest described in such section 127 (a), and if such obligations and liabilities were not so discharged or satisfied, the amount of such obligations and liabilities treated as discharged or satisfied under such section 127 (b) shall be considered for purposes of this part as a deduction by reason of such section 127 (a) which did not result in a reduction of any tax of the taxpayer under such chapters 1 or 2.

(5) ALLOWABLE DEDUCTION NOT ALLOWED.—For purposes of this subsection, an allowable deduction for any taxable year on account of the destruction or seizure of property described in such section 127 (a) shall, to the extent not allowed in computing the tax of the taxpayer for such taxable year, be considered an allowable deduction which did not result in a reduction of any tax of the taxpayer under such chapters 1 or 2.

SEC. 1333. TAX ADJUSTMENT MEASURED BY PRIOR BENEFITS.

If this section applies to the taxable year pursuant to an election made by the taxpayer under section 1335 or section 127 (c) (5) of the Internal Revenue Code of 1939—

(1) AMOUNT OF RECOVERY.—The amount of the recovery in the taxable year of any money or property in respect of property considered under section 127 (a) of the Internal Revenue Code of 1939 as destroyed or seized, shall be an amount equal to the aggregate of such money and the fair market value of such property, determined as of the date of the recovery. For purposes of this section, in the case of the recovery of the same property or interest considered under such section 127 (a) as destroyed or seized, the fair market value of such property or interest shall, at the option of the taxpayer, be considered an amount equal to the adjusted basis (for determining loss) of such property or interest in the hands of the taxpayer on the date such property or interest was considered under such section 127 (a) as destroyed or seized. The amount of the recovery determined under this paragraph shall be reduced for pur-

poses of paragraphs (2) and (3) by the amount of the obligations or liabilities with respect to the property considered under such section 127 (a) as destroyed or seized in respect of which the recovery was received, if the taxpayer for any previous taxable year chose under section 127 (b) (2) of such code to treat such obligations or liabilities as discharged or satisfied out of such property, and such obligations or liabilities were not so discharged or satisfied before the date of the recovery.

(2) ADJUSTMENT FOR PRIOR TAX BENEFITS.—That part of the amount of the recovery, in respect of any property considered under such section 127 (a) as destroyed or seized, which is not in excess of the allowable deductions in prior taxable years on account of such destruction or seizure of the property (the amount of such allowable deductions being first reduced by the aggregate amount of any prior recoveries in respect of the same property) shall be excluded from gross income for the taxable year of the recovery for purposes of computing the tax under this subtitle; but there shall be added to, and assessed and collected as a part of, the tax under this subtitle for the taxable year of the recovery the total increase in the tax under chapters 1 and 2 of the Internal Revenue Code of 1939 for all taxable years which would result by decreasing, in an amount equal to such part of the recovery so excluded, such deductions allowable in the prior taxable years with respect to the destruction or seizure of the property. Such increase in the tax for each such year so resulting shall be computed in accordance with regulations prescribed by the Secretary or his delegate. Such regulations shall give effect to previous recoveries of any kind (including recoveries described in section 111, relating to recovery of bad debts, etc.) with respect to any prior year, and shall provide for the case where there was no tax for the prior year, but shall otherwise treat the tax previously determined for any year in accordance with the principles set forth in section 1314 (a) (relating to corrections of errors). All credits allowable against the tax for any year and all carryovers and carrybacks affected by so decreasing the allowable deductions shall be taken into account in computing the increase in the tax, except that the computation of the excess profits credit under chapter 2 E of such code for any taxable year shall not be affected.

(3) GAIN ON RECOVERY.—The amount of any recovery or part thereof, in respect of property considered under such section 127 (a) as destroyed or seized, which is not excluded from gross income under paragraph (2), shall be considered for the taxable year of the recovery as gain on the involuntary conversion of property as a result of its destruction or seizure and shall be recognized or not recognized as provided in section 1033.

(4) RECOVERIES TREATED AS GROSS INCOME FOR CERTAIN PURPOSES.—For purposes of section 6012 (relating to persons required to make income tax returns) and section 1312 (relating to circumstances of adjustment), the recovery in the taxable year of any money or property in respect of property considered under such section 127 (a) as destroyed or seized in any prior taxable year shall be deemed to be an item includible in gross income for the taxable year in which the recovery is made.

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SEC. 1334. RESTORATION OF VALUE OF INVESTMENTS REFERABLE TO DESTROYED OR SEIZED PROPERTY.

For purposes of this part, the restoration in whole or in part of the value of any interest described in section 127 (a) (3) of the Internal Revenue Code of 1939 by reason of any recovery of money or property in respect of property to which such interest related and which was considered under subsection (a) (1) or (2) of such section 127 as destroyed or seized shall be deemed a recovery of property in respect of property considered under such section 127 (a) as destroyed or seized. In applying section 1333, such restoration shall be treated as the recovery of the same interest considered under such section 127 (a) as destroyed or seized.

SEC. 1335. ELECTION BY TAXPAYER FOR APPLICATION OF SECTION 1333.

If the taxpayer elects to have section 1333 apply to any taxable year in which he recovered any money or property in respect of property considered under section 127 (a) of the Internal Revenue Code of 1939, as destroyed or seized, section 1333 shall apply to all taxable years of the taxpayer beginning after December 31, 1941, and such election, once made, shall be irrevocable. The election shall be made in such manner and at such time as the Secretary or his delegate may by regulations prescribe, except that no election under this section may be made unless the taxpayer recovers money or property (in respect of property considered under such section 127 (a) as destroyed or seized) during the taxable year for which the election is made. If pursuant to such election section 1333 applies to any taxable year—

(1) the period of limitations provided in chapter 66 on the making of assessments and the beginning of distraint or a proceeding in court for collection shall not, with respect to—

(A) the amount to be added to the tax for such taxable year under section 1333, and

(B) any deficiency for such taxable year or for any other taxable year, to the extent attributable to the basis of the recovered property being determined under section 1336 (b),

expire before the expiration of 2 years following the date of the making of such election, and such amount and such deficiency may be assessed at any time before the expiration of such period notwithstanding any law or rule of law which would otherwise prevent such assessment and collection, and

(2) in case refund or credit of any overpayment resulting from the application of section 1333 to such taxable year is prevented on the date of the making of such election, or within one year from such date, by the operation of any law or rule of law (other than section 7122, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within one year from such date.

In the case of any taxable year ending before the date of the making by the taxpayer of an election under this section, no interest shall be paid on any overpayment resulting from the application of section 1333 to such taxable year, and no interest shall be assessed or collected with respect to any amount or any deficiency specified in

paragraph (1) for any period before the expiration of 6 months following the date of the making of such election by the taxpayer.

SEC. 1336. BASIS OF RECOVERED PROPERTY.

(a) IN GENERAL.—The unadjusted basis of property recovered in respect of property considered as destroyed or seized under section 127 (a) of the Internal Revenue Code of 1939 shall be determined under this section. Such basis shall be an amount equal to the fair market value of such property, determined as of the date of the recovery, reduced by an amount equal to the excess of the aggregate of such fair market value and the amounts of previous recoveries of money or property in respect of property considered under such section 127 (a) as destroyed or seized over the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of property described in such section 127 (a), and increased by that portion of the amount of the recovery which under section 1332 is treated as a recognized gain from the involuntary conversion of property. On application of the taxpayer, the aggregate of the bases (determined under the preceding sentence) of any properties recovered in respect of properties considered under such section 127 (a) as destroyed or seized may be allocated among the properties so recovered in such manner as the Secretary or his delegate may determine under regulations prescribed by the Secretary or his delegate, and the amounts so allocated to any such property so recovered shall be the unadjusted basis of such property in lieu of the unadjusted basis of such property determined under the preceding sentence.

(b) PROPERTY RECOVERED IN TAXABLE YEAR TO WHICH SECTION 1333 APPLIES.—In the case of a taxpayer who has made an election under section 1335, the basis of property recovered shall be an amount equal to the value at which such property is included in the amount of the recovery under section 1333 (1) (determined without regard to the last sentence thereof), reduced by such part of the gain under section 1333 (3) which is not recognized as provided in section 1033.

SEC. 1337. APPLICABLE RULES.

(a) DETERMINATION OF TAX BENEFITS.—The determination as to whether and to what extent an allowable deduction on account of the destruction or seizure of property described in section 127 (a) of the Internal Revenue Code of 1939 did or did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of such code shall be made in accordance with regulations prescribed by the Secretary or his delegate.

(b) PARTIAL WORTHLESSNESS OF CERTAIN INVESTMENTS TREATED AS WAR LOSSES UNDER 1939 CODE.—The part of the stock or other interest of the taxpayer treated under subsection (e) of such section 127 as property described in subsection (a) (3) of such section shall be treated in the same manner for purposes of this part.

PART V—CLAIM OF RIGHT

Sec. 1341. Computation of tax where taxpayer restores substantial amount held under claim of right.

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) GENERAL RULE.—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

For purposes of paragraph (5) (B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income).

(b) SPECIAL RULES.—

(1) If the decrease in tax ascertained under subsection (a) (5) (B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

(2) Subsection (a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This paragraph shall not apply if the deduction arises out of refunds or repayments made by a regulated public utility (as defined in section 1503 (c) without regard to paragraph (2) thereof) if such refunds or repayments are required to be made by the government, political subdivision, agency, or instrumentality referred to in such section.

PART VI—OTHER LIMITATIONS

Sec. 1346. Recovery of unconstitutional Federal taxes.
Sec. 1347. Claims against United States involving acquisition of property.

SEC. 1346. RECOVERY OF UNCONSTITUTIONAL FEDERAL TAXES.

Income (excluding interest) attributable to the recovery during the taxable year of a tax imposed by the United States which has been held unconstitutional, and in respect of which a deduction was allowed in a prior taxable year, may be excluded from gross income for the taxable year, and the deduction allowed in respect thereof in such prior taxable year treated as not having been allowable, if—

(1) the taxpayer elects in writing (at such time and in such manner as may be prescribed by regulations prescribed by the Secretary or his delegate) to treat such deduction as not having been allowable for such prior taxable year, and

(2) the taxpayer consents in writing to the assessment, within such period as may be agreed on, of any deficiency resulting from such treatment, even though the statutory period for the assessment of any such deficiency had expired before the filing of such consent.

SEC. 1347. CLAIMS AGAINST UNITED STATES INVOLVING ACQUISITION OF PROPERTY.

In the case of amounts (other than interest) received by a taxpayer from the United States with respect to a claim against the United States involving the acquisition of property and remaining unpaid for more than 15 years, the tax imposed by section 1 attributable to such receipt shall not exceed 30 percent of the amount (other than interest) so received.

Subchapter R—Election of Certain Partnerships and Proprietorships as to Taxable Status

Sec. 1361. Unincorporated business enterprises electing to be taxed as domestic corporations.

SEC. 1361. UNINCORPORATED BUSINESS ENTERPRISES ELECTING TO BE TAXED AS DOMESTIC CORPORATIONS.

(a) GENERAL RULE.—Subject to the qualifications in subsection (b), an election may be made, in accordance with regulations prescribed by the Secretary or his delegate, not later than 60 days after the close of any taxable year of a proprietorship or partnership owning an unincorporated business enterprise, by the proprietor or all the partners, owning an interest in such enterprise at any time on or after the first day of the first taxable year to which the election applies or of the year described in subsection (f), to be subject to the taxes described in subsection (h) as a domestic corporation for such year and subsequent years.

(b) QUALIFICATIONS.—The election described in subsection (a) may not be made with respect to an unincorporated business enterprise unless at all times during the period on or after the first day of the first taxable year to which the election applies or of the year described in subsection (f), as the case may be, and on or before the date of election—

(1) such enterprise is owned by an individual, or by a partnership consisting of not more than 50 individual members;

(2) no proprietor or partner having more than a 10 percent interest in profits or capital of such enterprise is a proprietor or a partner having more than a 10 percent interest in profits or capital of any other unincorporated business enterprise taxable as a domestic corporation;

(3) no proprietor or partner of such enterprise is a nonresident alien or a foreign partnership; and

(4) such enterprise is one in which capital is a material income producing factor, or 50 percent or more of the gross income of such enterprise consists of gains, profits, or income derived from trading as a principal or from buying and selling real property, stock, securities, or commodities for the account of others.

(c) CORPORATE PROVISIONS APPLICABLE.—Under regulations prescribed by the Secretary or his delegate, an unincorporated business enterprise as to which an election has been made under subsection (a), shall, except as provided in subsection (m), be considered a corporation for purposes of this subtitle, except chapter 2 thereof, with respect to operation, distributions, sale of an interest, and any other purpose; and each owner of an interest in such enterprise shall be considered a shareholder thereof in proportion to his interest.

(d) LIMITATION.—A partner or proprietor of an unincorporated business enterprise as to which an election has been made under subsection (a) shall not be considered an employee for purposes of section 401 (a) (relating to employees' pension trusts, etc.).

(e) ELECTION IRREVOCABLE.—Except as provided in subsection (f), the election described in subsection (a) shall be irrevocable—

(1) with respect to an enterprise as to which such election has been made and the proprietor or partners of such enterprise; and

(2) any unincorporated successor to the business of such enterprise and the proprietor or partners of such successor.

(f) CHANGE OF OWNERSHIP.—In any year in which the electing proprietor or partners have an interest of 80 percent or less in profits and capital of an enterprise described in subsection (e), such enterprise shall not be considered a domestic corporation for such year or for subsequent years unless the proprietor or partners of such enterprise make a new election in accordance with subsection (a).

(g) CONSTRUCTIVE OWNERSHIP.—For purposes of subsection (f), the ownership of an interest shall be determined in accordance with the rules for constructive ownership of stock provided in section 267 (c) other than paragraph (3) thereof.

(h) IMPOSITION OF TAXES.—The unincorporated business enterprise as to which an election has been made under subsection (a) shall be subject to—

(1) the normal tax and surtax imposed by section 11,

(2) the accumulated earnings tax imposed by section 531, and

(3) the alternative tax for capital gains imposed by section 1201.

(i) PERSONAL HOLDING COMPANY INCOME.—

(1) EXCLUDED FROM INCOME OF ENTERPRISE.—There shall not be included in the gross income of the enterprise as to which an election has been made under subsection (a) any personal holding company income (as defined in section 543), except income earned by such enterprise from buying and selling real property, stock, securities, or commodities for the account of others.

(2) INCOME AND DEDUCTIONS OF OWNERS.—Any personal holding company income not included in the gross income of the enterprise under paragraph (1), and the expenses attributable thereto, shall be treated as the income and deductions of the proprietor or partners (in accordance with their distributive shares of partnership income) of such enterprise.

(3) DISTRIBUTIONS.—If the amount of personal holding company income includible under paragraph (2) in the income of the proprietor or partner is distributed to him during the year earned, such amount shall not be taxed as a corporate distribution. The amount of such income not distributed during such year shall be considered as paid-in surplus or as a contribution to capital as of the close of such year.

(4) RENTS AND ROYALTIES.—For the purpose of determining whether rents, and mineral, oil, or gas royalties constitute personal holding company income under paragraph (1), all income earned by the enterprise in any taxable year shall enter into the determination of its gross income for such year.

(j) COMPUTATION OF TAXABLE INCOME.—In computing the taxable income of an unincorporated business enterprise as to which an election has been made under subsection (a)—

(1) a reasonable deduction shall be allowed for salary or compensation to a proprietor or partner for services actually rendered; and

(2) there shall be allowed as deductions only such items properly allocable to the operation of the business of such enterprise, except deductions allocable to the proprietor or partners under subsection (i) (2).

(k) DISTRIBUTIONS OTHER THAN IN LIQUIDATION.—Except as provided in subsection (l), a distribution with respect to a proprietorship or partnership interest by an enterprise as to which an election has been made under subsection (a), other than a distribution of personal holding company income under subsection (i) (3), shall be treated as a corporate distribution in accordance with part I of subchapter C of this chapter.

(l) DISTRIBUTIONS IN LIQUIDATION.—A distribution in partial or complete liquidation with respect to a proprietorship or partnership interest by an enterprise as to which an election has been made under subsection (a), shall be treated as a corporate liquidation in accordance with part II of subchapter C of this chapter.

(m) ORGANIZATIONS AND REORGANIZATIONS.—An enterprise as to which an election has been made under subsection (a) shall not be considered a corporation, nor shall the proprietor or partners of such enterprise be considered shareholders, for purposes of parts III and IV of subchapter C of this chapter (relating to corporate organizations, and reorganizations, and insolvency reorganizations) except in the case of—

(1) a contribution of property, constituting either paid-in surplus or a contribution to capital, on which gain or loss is recognized; and

(2) the organization of an enterprise as to which the election described in subsection (a) is made for its first taxable year.

CHAPTER 2—TAX ON SELF-EMPLOYMENT INCOME

Sec. 1401. Rate of tax.
Sec. 1402. Definitions.
Sec. 1403. Miscellaneous provisions.

SEC. 1401. RATE OF TAX.

In addition to other taxes, there shall be imposed for each taxable year, on the self-employment income of every individual, a tax as follows:

(1) in the case of any taxable year beginning before January 1, 1960, the tax shall be equal to 3 percent of the amount of the self-employment income for such taxable year;

(2) in the case of any taxable year beginning after December 31, 1959, and before January 1, 1965, the tax shall be equal to 3¾ percent of the amount of the self-employment income for such taxable year;

(3) in the case of any taxable year beginning after December 31, 1964, and before January 1, 1970, the tax shall be equal to 4½ percent of the amount of the self-employment income for such taxable year;

(4) in the case of any taxable year beginning after December 31, 1969, the tax shall be equal to 4⅞ percent of the amount of the self-employment income for such taxable year.

SEC. 1402. DEFINITIONS.

(a) NET EARNINGS FROM SELF-EMPLOYMENT.—The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702 (a) (9) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

(1) there shall be excluded rentals from real estate (including personal property leased with the real estate) and deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer;

(2) there shall be excluded income derived from any trade or business in which, if the trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121 (g); and there shall be excluded all deductions attributable to such income;

(3) there shall be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), unless such dividends and

interest (other than interest described in section 35) are received in the course of a trade or business as a dealer in stocks or securities;

(4) there shall be excluded any gain or loss—

(A) which is considered as gain or loss from the sale or exchange of a capital asset,

(B) from the cutting of timber, or the disposal of timber or coal, if section 631 applies to such gain or loss, or

(C) from the sale, exchange, involuntary conversion. or other disposition of property if such property is neither—

(i) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor

(ii) property held primarily for sale to customers in the ordinary course of the trade or business;

(5) the deduction for net operating losses provided in section 172 shall not be allowed;

(6) if—

(A) any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife; and

(B) any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner;

(7) a resident of Puerto Rico shall compute his net earnings from self-employment in the same manner as a citizen of the United States but without regard to section 933;

(8) the deduction for personal exemptions provided in section 151 shall not be allowed.

If the taxable year of a partner is different from that of the partnership, the distributive share which he is required to include in computing his net earnings from self-employment shall be based on the ordinary income or loss of the partnership for any taxable year of the partnership ending within or with his taxable year.

(b) SELF-EMPLOYMENT INCOME.—The term "self-employment income" means the net earnings from self-employment derived by an individual (other than a nonresident alien individual) during any taxable year; except that such term shall not include—

(1) that part of the net earnings from self-employment which is in excess of—

(A) $3,600, minus

(B) the amount of the wages paid to such individual during the taxable year; or

(2) the net earnings from self-employment, if such net earnings for the taxable year are less than $400.

For purposes of clause (1), the term "wages" includes such remuneration paid to an employee for services included under an agreement entered into pursuant to the provisions of section 218 of the Social Security Act (relating to coverage of State employees) as would be wages under section 3121 (a) if such services constituted employment under section 3121 (b). An individual who is not a citizen of the United States but who is a resident of the Virgin Islands or a resident of Puerto Rico shall not, for purposes of this chapter be considered to be a nonresident alien individual.

(c) TRADE OR BUSINESS.—The term "trade or business", when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses), except that such term shall not include—

(1) the performance of the functions of a public office;

(2) the performance of service by an individual as an employee (other than service described in section 3121 (b) (16) (B) performed by an individual who has attained the age of 18);

(3) the performance of service by an individual as an employee or employee representative as defined in section 3231;

(4) the performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order; or

(5) the performance of service by an individual in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, Christian Science practitioner, architect, certified public accountant, accountant registered or licensed as an accountant under State or municipal law, full-time practicing public accountant, funeral director, or professional engineer; or the performance of such service by a partnership.

(d) EMPLOYEE AND WAGES.—The term "employee" and the term "wages" shall have the same meaning as when used in chapter 21 (sec. 3101 and following, relating to Federal Insurance Contributions Act).

SEC. 1403. MISCELLANEOUS PROVISIONS.

(a) TITLE OF CHAPTER.—This chapter may be cited as the "Self-Employment Contributions Act of 1954".

(b) CROSS REFERENCES.—

(1) For provisions relating to returns, see section 6017.

(2) For provisions relating to collection of taxes in Virgin Islands and Puerto Rico, see section 7651.

(2) the net earnings from self-employment, if such net earnings for the taxable year are less than $400.

For purposes of clause (1), the term "wages" includes such remuneration paid to an employee for services included under an agreement entered into pursuant to the provisions of section 218 of the Social Security Act (relating to coverage of State employees) as would be wages under section 3121 (a) if such services constituted employment under section 3121 (b). An individual who is not a citizen of the United States but who is a resident of the Virgin Islands or a resident of Puerto Rico shall not, for purposes of this chapter be considered to be a nonresident alien individual.

(c) TRADE OR BUSINESS.—The term "trade or business", when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses), except that such term shall not include—

(1) the performance of the functions of a public office;

(2) the performance of service by an individual as an employee (other than service described in section 3121 (b) (19) (B) performed by an individual who has attained the age of 18);

(3) the performance of service by an individual as an employee or employee representative as defined in section 3231;

(4) the performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order; or

(5) the performance of service by an individual in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, Christian Science practitioner, architect, certified public accountant, accountant registered or licensed as an accountant under State or municipal law, full-time practicing public accountant, funeral director, or professional engineer; or the performance of such service by a partnership.

(d) EMPLOYEES AND WAGES.—The term "employee" and the term "wages" shall have the same meaning as when used in chapter 21 (sec. 3101 and following, relating to Federal Insurance Contributions Act).

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CHAPTER 3—WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS AND TAX-FREE COVENANT BONDS

SUBCHAPTER A. Nonresident aliens and foreign corporations.
SUBCHAPTER B. Tax-free covenant bonds.
SUBCHAPTER C. Application of withholding provisions.

Subchapter A—Nonresident Aliens and Foreign Corporations

Sec. 1441. Withholding of tax on nonresident aliens.
Sec. 1442. Withholding of tax on foreign corporations.
Sec. 1443. Foreign tax-exempt organizations.

SEC. 1441. WITHHOLDING OF TAX ON NONRESIDENT ALIENS.

(a) GENERAL RULE.—Except as otherwise provided in subsection (c), all persons, in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States) having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual, or of any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, shall (except in the cases provided for in section 1451 and except as otherwise provided in regulations prescribed by the Secretary or his delegate under section 874) deduct and withhold from such items a tax equal to 30 percent thereof.

(b) INCOME ITEMS.—The items of income referred to in subsection (a) are interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, and amounts described in section 402 (a) (2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets.

(c) EXCEPTIONS.—

(1) DIVIDENDS OF FOREIGN CORPORATIONS.—No deduction or withholding under subsection (a) shall be required in the case of dividends paid by a foreign corporation unless (A) such corporation is engaged in trade or business within the United States, and (B) more than 85 percent of the gross income of such corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under part I of subchapter N of chapter 1.

(2) OWNER UNKNOWN.—The Secretary or his delegate may authorize the tax under subsection (a) to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(3) BONDS WITH EXTENDED MATURITY DATES.—The deduction and withholding in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation, within subsections (a), (b), and (c) of section 1451 were it not for the fact that the maturity date of such obligations has been extended on or after January 1, 1934, and the liability assumed by the debtor exceeds 27½ percent of the interest, shall not exceed the rate of 27½ percent per annum.

(4) COMPENSATION OF CERTAIN ALIENS.—Under regulations prescribed by the Secretary or his delegate, there may be exempted from deduction and withholding under subsection (a) the compensation for personal services of nonresident alien individuals who enter and leave the United States at frequent intervals.

(5) SPECIAL ITEMS.—In the case of amounts described in section 402 (a) (2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets, the amount required to be deducted and withheld shall, if the amount of such gain is not known to the withholding agent, be such amount, not exceeding 30 percent of the proceeds from such sale or exchange, as may be necessary to assure that the tax deducted and withheld shall not be less than 30 percent of such gain.

(d) ALIEN RESIDENT OF PUERTO RICO.—For purposes of this section, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

SEC. 1442. WITHHOLDING OF TAX ON FOREIGN CORPORATIONS.

In the case of foreign corporations subject to taxation under this subtitle not engaged in trade or business within the United States, 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 or section 1451 a tax equal to 30 percent thereof; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein.

SEC. 1443. FOREIGN TAX-EXEMPT ORGANIZATIONS.

In the case of income of a foreign organization subject to the tax imposed by section 511, this chapter shall apply to rents includible under section 512 in computing its unrelated business taxable income, but only to the extent and subject to such conditions as may be provided under regulations prescribed by the Secretary or his delegate.

Subchapter B—Tax-Free Covenant Bonds

Sec. 1451. Tax-free covenant bonds.

SEC. 1451. TAX-FREE COVENANT BONDS.

(a) REQUIREMENT OF WITHHOLDING.—In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, issued before January 1, 1934, contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this subtitle on the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 percent (regardless of whether the liability assumed by the obligor is less than, equal to, or greater than 2 percent) of the interest on such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods, if payable to—

(1) an individual,

(2) a partnership, or

(3) a foreign corporation not engaged in trade or business within the United States.

(b) PAYMENTS TO FOREIGNERS.—Notwithstanding subsection (a), if the liability assumed by the obligor does not exceed 2 percent of the interest, then the deduction and withholding shall be at the rate of 30 percent in the case of—

(1) a nonresident alien individual,

(2) any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, and

(3) a foreign corporation not engaged in trade or business within the United States.

(c) OWNER UNKNOWN.—If the owners of such obligations are not known to the withholding agent, the Secretary or his delegate may authorize such deduction and withholding to be at the rate of 2 percent, or, if the liability assumed by the obligor does not exceed 2 percent of the interest, then at the rate of 30 percent.

(d) BENEFIT OF PERSONAL EXEMPTIONS.—Deduction and withholding under this section shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the deduction for personal exemptions provided in section 151; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Secretary or his delegate under section 874.

(e) ALIEN RESIDENTS OF PUERTO RICO.—For purposes of this section, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

(f) INCOME OF OBLIGOR AND OBLIGEE.—The obligor shall not be allowed a deduction for the payment of the tax imposed by this subtitle, or any other tax paid pursuant to the tax-free covenant clause, nor shall such tax be included in the gross income of the obligee.

Subchapter C—Application of Withholding Provisions

Sec. 1461. Return and payment of withheld tax.
Sec. 1462. Withheld tax as credit to recipient of income.
Sec. 1463. Tax paid by recipient of income.
Sec. 1464. Refunds and credits with respect to withheld tax.
Sec. 1465. Definition of withholding agent.

SEC. 1461. RETURN AND PAYMENT OF WITHHELD TAX.

Every person required to deduct and withhold any tax under this chapter shall, on or before March 15 of each year, make return thereof and pay the tax to the officer designated in section 6151. Every such person is hereby made liable for such tax and is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this chapter.

SEC. 1462. WITHHELD TAX AS CREDIT TO RECIPIENT OF INCOME.

Income on which any tax is required to be withheld at the source under this chapter shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

SEC. 1463. TAX PAID BY RECIPIENT OF INCOME.

If any tax required under this chapter to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed on or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

SEC. 1464. REFUNDS AND CREDITS WITH RESPECT TO WITHHELD TAX.

Where there has been an overpayment of tax under this chapter, any refund or credit made under chapter 65 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent.

SEC. 1465. DEFINITION OF WITHHOLDING AGENT.

The term "withholding agent" means any person required to deduct and withhold any tax under this chapter.

CHAPTER 4—RULES APPLICABLE TO RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS

SUBCHAPTER A. Recovery of excessive profits on government contracts.
SUBCHAPTER B. Mitigation of effect of renegotiation of government contracts.

Subchapter A—Recovery of Excessive Profits on Government Contracts

Sec. 1471. Recovery of excessive profits on Government contracts.

SEC. 1471. RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS.

(a) METHOD OF COLLECTION.—If the amount of profit required to be paid into the Treasury under section 3 of the Act of March 27, 1934, as amended (34 U. S. C. 496), with respect to contracts completed within taxable years subject to this code is not voluntarily paid, the Secretary or his delegate shall collect the same under the methods employed to collect taxes under this subtitle.

(b) LAWS APPLICABLE.—All provisions of law (including penalties) applicable with respect to the taxes imposed by this subtitle and not inconsistent with section 3 of the Act of March 27, 1934, as amended, shall apply with respect to the assessment, collection, or payment of excess profits to the Treasury as provided by subsection (a), and to refunds by the Treasury of overpayments of excess profits into the Treasury.

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Subchapter B—Mitigation of Effect of Renegotiation of Government Contracts

Sec. 1481. Mitigation of effect of renegotiation of government contracts.

SEC. 1481. MITIGATION OF EFFECT OF RENEGOTIATION OF GOVERNMENT CONTRACTS.

(a) REDUCTION FOR PRIOR TAXABLE YEAR.—

(1) EXCESSIVE PROFITS ELIMINATED FOR PRIOR TAXABLE YEAR.—In the case of a contract with the United States or any agency thereof, or any subcontract thereunder, which is made by the taxpayer, if a renegotiation is made in respect of such contract or subcontract and an amount of excessive profits received or accrued under such contract or subcontract for a taxable year (referred to in this section as "prior taxable year") is eliminated and, the taxpayer is required to pay or repay to the United States or any agency thereof the amount of excessive profits eliminated or the amount of excessive profits eliminated is applied as an offset against other amounts due the taxpayer, the part of the contract or subcontract price which was received or was accrued for the prior taxable year shall be reduced by the amount of excessive profits eliminated. For purposes of this section—

(A) The term "renegotiation" includes any transaction which is a renegotiation within the meaning of the Federal renegotiation act applicable to such transaction, any modification of one or more contracts with the United States or any agency thereof, and any agreement with the United States or any agency thereof in respect of one or more such contracts or subcontracts thereunder.

(B) The term "excessive profits" includes any amount which constitutes excessive profits within the meaning assigned to such term by the applicable Federal renegotiation act, any part of the contract price of a contract with the United States or any agency thereof, any part of the subcontract price of a subcontract under such a contract, and any profits derived from one or more such contracts or subcontracts.

(C) The term "subcontract" includes any purchase order or agreement which is a subcontract within the meaning assigned to such term by the applicable Federal renegotiation act.

(D) The term "Federal renegotiation act" includes section 403 of the Sixth Supplemental National Defense Appropriation Act (Public Law 528, 77th Cong., 2d Sess.), as amended or supplemented, the Renegotiation Act of 1948, as amended or supplemented, and the Renegotiation Act of 1951, as amended or supplemented.

(2) REDUCTION OF REIMBURSEMENT FOR PRIOR TAXABLE YEAR.—In the case of a cost-plus-a-fixed-fee contract between the United States or any agency thereof and the taxpayer, if an item for which the taxpayer has been reimbursed is disallowed as an item

of cost chargeable to such contract and the taxpayer is required to repay the United States or any agency thereof the amount disallowed or the amount disallowed is applied as an offset against other amounts due the taxpayer, the amount of the reimbursement of the taxpayer under the contract for the taxable year in which the reimbursement for such item was received or was accrued shall be reduced by the amount disallowed.

(3) DEDUCTION DISALLOWED.—The amount of the payment, repayment, or offset described in paragraph (1) or paragraph (2) shall not constitute a deduction for the year in which paid or incurred.

(4) EXCEPTION.—The foregoing provisions of this subsection shall not apply in respect of any contract if the taxpayer shows to the satisfaction of the Secretary or his delegate that a different method of accounting for the amount of the payment, repayment, or disallowance clearly reflects income, and in such case the payment, repayment, or disallowance shall be accounted for with respect to the taxable year provided for under such method, which for the purposes of subsections (b) and (c) shall be considered a prior taxable year.

(b) CREDIT AGAINST REPAYMENT ON ACCOUNT OF RENEGOTIATION OR ALLOWANCE.—

(1) GENERAL RULE.—There shall be credited against the amount of excessive profits eliminated the amount by which the tax for the prior taxable year under this subtitle is decreased by reason of the application of paragraph (1) of subsection (a); and there shall be credited against the amount disallowed the amount by which the tax for the prior taxable year under this subtitle is decreased by reason of the application of paragraph (2) of subsection (a).

(2) CREDIT FOR BARRED YEAR.—If at the time of the payment, repayment, or offset described in paragraph (1) or paragraph (2) of subsection (a), refund or credit of tax under this subtitle for the prior taxable year is prevented (except for the provisions of section 1311) by any provision of the internal revenue laws other than section 7122, or by rule of law, the amount by which the tax for such year under this subtitle is decreased by the application of paragraph (1) or paragraph (2) of subsection (a) shall be computed under this paragraph. There shall first be ascertained the tax previously determined for the prior taxable year. The amount of the tax previously determined shall be the excess of—

(A) the sum of—

(i) the amount shown as the tax by the taxpayer on his return (determined as provided in section 6211 (b) (1) and (3)), if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(ii) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(B) the amount of rebates, as defined in section 6211 (b) (2), made.

There shall then be ascertained the decrease in tax previously determined which results solely from the application of paragraph (1) or paragraph (2) of subsection (a) to the prior taxable year. The amount so ascertained, together with any amounts collected

as additions to the tax or interest, as a result of paragraph (1) or paragraph (2) of subsection (a) not having been applied to the prior taxable year, shall be the amount by which such tax is decreased.

(3) INTEREST.—In determining the amount of the credit under this subsection no interest shall be allowed with respect to the amount ascertained under paragraph (1); except that if interest is charged by the United States or the agency thereof on account of the disallowance for any period before the date of the payment, repayment, or offset, the credit shall be increased by an amount equal to interest on the amount ascertained under such paragraph at the same rate and for the period (prior to the date of the payment, repayment, or offset) as interest is so charged.

(c) CREDIT IN LIEU OF OTHER CREDIT OR REFUND.—If a credit is allowed under subsection (b) with respect to a prior taxable year no other credit or refund under the internal-revenue laws founded on the application of subsection (a) shall be made on account of the amount allowed with respect to such taxable year. If the amount allowable as a credit under subsection (b) exceeds the amount allowed under such subsection, the excess shall, for purposes of the internal revenue laws relating to credit or refund of tax, be treated as an overpayment for the prior taxable year which was made at the time the payment, repayment, or offset was made.

(d) RENEGOTIATION OF GOVERNMENT CONTRACTS AFFECTING TAXABLE YEARS PRIOR TO 1954.—If a recovery of excessive profits through renegotiation as described in this section relates to profits of a taxable year subject to the Internal Revenue Code of 1939, the adjustments in respect of such renegotiation shall be made under section 3806 of such code.

CHAPTER 5—TAX ON TRANSFERS TO AVOID INCOME TAX

Sec. 1491. Imposition of tax.
Sec. 1492. Nontaxable transfers.
Sec. 1493. Definition of foreign trust.
Sec. 1494. Payment and collection.

SEC. 1491. IMPOSITION OF TAX.

There is hereby imposed on the transfer of stock or securities by a citizen or resident of the United States, or by a domestic corporation or partnership, or by a trust which is not a foreign trust, to a foreign corporation as paid-in surplus or as a contribution to capital, or to a foreign trust, or to a foreign partnership, an excise tax equal to 27½ percent of the excess of—

(1) the value of the stock or securities so transferred, over

(2) its adjusted basis (for determining gain) in the hands of the transferor.

SEC. 1492. NONTAXABLE TRANSFERS.

The tax imposed by section 1491 shall not apply—

(1) If the transferee is an organization exempt from income tax under part I of subchapter F of chapter 1 (other than an organization described in section 401 (a)); or

(2) If before the transfer it has been established to the satisfaction of the Secretary or his delegate that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

SEC. 1493. DEFINITION OF FOREIGN TRUST.

A trust shall be considered a foreign trust within the meaning of this chapter if, assuming a subsequent sale by the trustee, outside the United States and for cash, of the property so transferred, the profit, if any, from such sale would not be included in the gross income of the trust under this subtitle.

SEC. 1494. PAYMENT AND COLLECTION.

(a) TIME FOR PAYMENT.—The tax imposed by section 1491 shall, without assessment or notice and demand, be due and payable by the transferor at the time of the transfer, and shall be assessed, collected, and paid under regulations prescribed by the Secretary or his delegate.

(b) ABATEMENT OR REFUND.—Under regulations prescribed by the Secretary or his delegate, the tax may be abated, remitted, or refunded if after the transfer it has been established to the satisfaction of the Secretary or his delegate that such transfer was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

CHAPTER 5—TAX ON TRANSFERS TO AVOID INCOME TAX

Sec. 1491. Imposition of tax.
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(b) AMENDMENT OF RETURN.—Under regulations prescribed by the Secretary or his delegate, the tax may be abated, remitted, or refunded if after the transfer it has been established to the satisfaction of the Secretary or his delegate that such transfer was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

CHAPTER 6—CONSOLIDATED RETURNS

SUBCHAPTER A. Returns and payment of tax.
SUBCHAPTER B. Related rules.

Subchapter A—Returns and Payment of Tax

Sec. 1501. Privilege to file consolidated returns.
Sec. 1502. Regulations.
Sec. 1503. Computation and payment of tax.
Sec. 1504. Definitions.
Sec. 1505. Cross references.

SEC. 1501. PRIVILEGE TO FILE CONSOLIDATED RETURNS.

An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed 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. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

SEC. 1502. REGULATIONS.

The Secretary or his delegate shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

SEC. 1503. COMPUTATION AND PAYMENT OF TAX.

(a) GENERAL RULE.—In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502 prescribed prior to the last day prescribed by law for the filing of such return; except that the tax imposed under section 11 (c) or section 831 shall be increased for any taxable year by 2 percent of the consolidated taxable income of the affiliated group of includible corporations. For purposes of this section, the term "consolidated taxable income" means the consolidated taxable income computed without regard to the deduction provided by section 242 for partially tax-exempt interest.

(b) LIMITATION.—If the affiliated group includes one or more Western Hemisphere trade corporations (as defined in section 921) or one or more regulated public utilities (as defined in subsection (c)), the increase of 2 percent provided in subsection (a) shall be applied only on the amount by which the consolidated taxable income of the affiliated group exceeds the portion (if any) of the consolidated taxable income attributable to the Western Hemisphere trade corporations and regulated public utilities included in such group.

(c) REGULATED PUBLIC UTILITY DEFINED.—

(1) IN GENERAL.—For purposes of subsection (b), the term "regulated public utility" means—

(A) A corporation engaged in the furnishing or sale of—

(i) electric energy, gas, water, or sewerage disposal services, or

(ii) transportation (not included in subparagraph (C)) on an intrastate, suburban, municipal, or interurban electric railroad, on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system, or

(iii) transportation (not included in clause (ii)) by motor vehicle—

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

(B) A corporation engaged as a common carrier in the furnishing or sale of transportation of gas by pipeline, if subject to the jurisdiction of the Federal Power Commission.

(C) A corporation engaged as a common carrier (i) in the furnishing or sale of transportation by railroad, if subject to the jurisdiction of the Interstate Commerce Commission, or (ii) in the furnishing or sale of transportation of oil or other petroleum products (including shale oil) by pipe line, if subject to the jurisdiction of the Interstate Commerce Commission or if the rates for such furnishing or sale are subject to the jurisdiction of a public service or public utility commission or other similar body of the District of Columbia or of any State.

(D) A corporation engaged in the furnishing or sale of telephone or telegraph service, if the rates for such furnishing or sale meet the requirements of subparagraph (A).

(E) A corporation engaged in the furnishing or sale of transportation as a common carrier by air, subject to the jurisdiction of the Civil Aeronautics Board.

(F) A corporation engaged in the furnishing or sale of transportation by common carrier by water, subject to the jurisdiction of the Interstate Commerce Commission under part III of the Interstate Commerce Act, or subject to the jurisdiction of the Federal Maritime Board under the Intercoastal Shipping Act, 1933.

(2) LIMITATION.—For purposes of subsection (b), the term "regulated public utility" does not (except as provided in paragraph (3))

include a corporation described in paragraph (1) unless 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from sources described in paragraph (1). If the taxpayer establishes to the satisfaction of the Secretary or his delegate that—

(A) its revenue from regulated rates described in paragraph (1) (A) or (D) and its revenue derived from unregulated rates are derived from its operation of a single interconnected and coordinated system or from the operation of more than one such system, and

(B) the unregulated rates have been and are substantially as favorable to users and consumers as are the regulated rates,

such revenue from such unregulated rates shall be considered, for purposes of this paragraph, as income derived from sources described in paragraph (1) (A) or (D).

(3) CERTAIN RAILROAD CORPORATIONS.—

(A) LESSOR CORPORATION.—For purposes of subsection (b), the term "regulated public utility" shall also include a railroad corporation subject to part I of the Interstate Commerce Act, if (i) substantially all of its railroad properties have been leased to another such railroad corporation or corporations by an agreement or agreements entered into prior to January 1, 1954, (ii) each lease is for a term of more than 20 years, and (iii) at least 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from such leases and from sources described in paragraph (1). For purposes of the preceding sentence, an agreement for lease of railroad properties entered into prior to January 1, 1954, shall be considered to be a lease including such term as the total number of years of such agreement may, unless sooner terminated, be renewed or continued under the terms of the agreement, and any such renewal or continuance under such agreement shall be considered part of the lease entered into prior to January 1, 1954.

(B) COMMON PARENT CORPORATION.—For purposes of subsection (b), the term "regulated public utility" also includes a common parent corporation which is a common carrier by railroad subject to part I of the Interstate Commerce Act if at least 80 percent of its gross income (computed without regard to capital gains or losses) is derived directly or indirectly from sources described in paragraph (1). For purposes of the preceding sentence, dividends and interest, and income from leases described in subparagraph (A), received from a regulated public utility shall be considered as derived from sources described in paragraph (1) if the regulated public utility is a member of an affiliated group (as defined in section 1504) which includes the common parent corporation.

SEC. 1504. DEFINITIONS.

(a) DEFINITION OF "AFFILIATED GROUP".—As used in this chapter, 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 this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(b) DEFINITION OF "INCLUDIBLE CORPORATION".—As used in this chapter, the term "includible corporation" means any corporation except—

(1) Corporations exempt from taxation under section 501.

(2) Insurance companies subject to taxation under section 802 or 821.

(3) Foreign corporations.

(4) Corporations entitled to the benefits of section 931, by reason of receiving a large percentage of their income from sources within possessions of the United States.

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

(6) Regulated investment companies subject to tax under subchapter M of chapter 1.

(7) Unincorporated business enterprises subject to tax as corporations under section 1361.

(c) INCLUDIBLE INSURANCE COMPANIES.—Despite the provisions of paragraph (2) of subsection (b), two or more domestic insurance companies each of which is subject to taxation under the same section of this subtitle shall be considered as includible corporations for the purpose of the application of subsection (a) to such insurance companies alone.

(d) SUBSIDIARY FORMED TO COMPLY WITH FOREIGN LAW.—In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subtitle as a domestic corporation.

SEC. 1505. CROSS REFERENCES.

(1) For suspension of running of statute of limitations when notice in respect of a deficiency is mailed to one corporation, see section 6503 (a) (1).

(2) For allocation of income and deductions of related trades or businesses, see section 482.

Subchapter B—Related Rules

Sec. 1551. Disallowance of surtax exemption and accumulated earnings credit.
Sec. 1552. Earnings and profits.

SEC. 1551. DISALLOWANCE OF SURTAX EXEMPTION AND ACCUMULATED EARNINGS CREDIT.

If any corporation transfers, on or after January 1, 1951, all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year (except as may be otherwise determined under section 269 (b)) be allowed either the $25,000 exemption from surtax provided in section 11 (c) or the $60,000 accumulated earnings credit provided in paragraph (2) or (3) of section 535 (c), unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. For purposes of this section, control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of the corporation. In determining the ownership of stock for the purpose of this section, the ownership of stock shall be determined in accordance with the provisions of section 544, except that constructive ownership under section 544 (a) (2) shall be determined only with respect to the individual's spouse and minor children. The provisions of section 269 (b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with the provisions of this section, be applicable to this section.

SEC. 1552. EARNINGS AND PROFITS.

(a) General Rule.—Pursuant to regulations prescribed by the Secretary or his delegate the earnings and profits of each member of an affiliated group required to be included in a consolidated return for such group filed for a taxable year beginning after December 31, 1953, and ending after the date of enactment of this title, shall be determined by allocating the tax liability of the group for such year among the members of the group in accord with whichever of the following methods the group shall elect in its first consolidated return filed for such a taxable year:

(1) The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income.

(2) 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 tax which 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.

(3) The tax liability of the group (excluding the tax increases arising from the consolidation) shall be allocated on the basis of the contribution of each member of the group to the consolidated taxable income of the group. Any tax increases arising from the consolidation shall be distributed to the several members in direct proportion to the reduction in tax liability resulting to such members from the filing of the consolidated return as measured by the difference between their tax liabilities determined on a separate return basis and their tax liabilities (determined without regard to the 2 percent increase provided by section 1503 (a)) based on their contributions to the consolidated taxable income.

(4) The tax liability of the group shall be allocated in accord with any other method selected by the group with the approval of the Secretary or his delegate.

(b) FAILURE TO ELECT.—If no election is made in such first return, the tax liability shall be allocated among the several members of the group pursuant to the method prescribed in subsection (a) (1).