Such consents shall not be construed to shorten the period described in section 6501 for any taxable year within the presumption period to which the election applies.

(3) The statement, with the required consents attached, shall be filed—

(i) With the service center at which the taxpayer making the election is required to file his return, or

(ii) If the taxpayer is notified by a district director that, pursuant to section 183 he is proposing to disallow deductions with respect to an activity not engaged in for profit, with such district director.

(e) Subsequent invalidations. If, after a timely election has been made, but still within the presumption period, a suit or proceeding (as described in section 7422(a)) is maintained by the electing taxpayer, a shareholder referred to in paragraph (d)(2)(ii) of this section, or spouse referred to in paragraph (d)(2)(iii) of this section for any taxable year for which a consent is required by this section and the taxpayer, shareholder, or spouse has not been issued a notice of deficiency (as described in section 6212(a)) with respect to such taxable year, such election shall not be effective to postpone the determination whether the presumption applies, for such taxable year, but the consents extending the statute of limitations filed with the election shall not thereby be invalidated. The immediately preceding sentence shall not apply to a suit or proceeding maintained by the spouse of an electing taxpayer for a taxable year for which such spouse has filed a separate return, or a suit or proceeding maintained by a shareholder for a taxable year in which he was not such a shareholder. An election by an individual taxpayer or electing small business corporation, shall be subsequently invalidated for all years in the presumption period to which the election applies and does not, within 90 days after the date on which he becomes a shareholder (or, if later, 90 days after March 14, 1974), file a consent required by paragraph (d)(2) of this section. Invalidation of the election by operation of this paragraph will in no case affect the validity of the consents filed with such election.

(f) Extension of time for filing election in hardship cases. The Commissioner may upon application by a taxpayer, consent to an extension of time prescribed in this section for making an election if he finds that such an extension would be justified by hardship incurred by reason of the time at which this section is published. The burden will be on the taxpayer to establish that under the relevant facts the Commissioner should so consent.

[T.D. 7308, 39 FR 9947, Mar. 15, 1974]
section 103(d)(2)) shall be treated as an obligation not described in section 103(a)(1). Thus, the interest on an obligation which would have been excluded from gross income pursuant to the provisions of section 103(a)(1) will be included in gross income and subject to Federal income taxation if such obligation is an arbitrage bond. Under section 103(d)(2), an obligation is an arbitrage bond if it is issued by a governmental unit as part of an issue of obligations (for purposes of this section referred to as “governmental obligations”) all or a major portion of the proceeds of which are (i) reasonably expected to be used directly or indirectly to acquire certain obligations or securities (for purposes of this section referred to as “acquired obligations”) which may reasonably be expected, at the time of issuance of such governmental obligations, to produce a yield over the term of the issue of such governmental obligations which is materially higher (taking into account any discount or premium) than the yield on such issue, or (ii) reasonably expected to be used to replace funds which were used directly or indirectly to acquire such acquired obligations. For rules as to industrial development bonds, see section 103(c).

(2) Definitions. (i) For purposes of this section, the term “governmental unit” means a State, the District of Columbia, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing.

(ii) For purposes of this section, the term “securities” has the same meaning as in section 165(g)(2) (A) and (B).

(3) Materially higher. For purposes of this section, the yield produced by acquired obligations is not “materially higher” than the yield produced by an issue of governmental obligations if it is reasonably expected, at the time of issue of such governmental obligations, that the adjusted yield (computed in accordance with subparagraphs (4) and (5) of this paragraph) to be produced by the acquired obligations will not exceed the adjusted yield (computed in accordance with subparagraphs (4) and (5) of this paragraph) to be produced by the issue of governmental obligations by more than one-eighth of 1 percentage point. In the case of an issue of governmental obligations issued on or before July 1, 1972, the percentage specified in the preceding sentence shall be one-half of 1 percentage point.

(4) Yield. (i) For purposes of this section, “yield” shall be computed using the “interest cost per annum” method in accordance with subdivision (ii) or (iii) of this subparagraph (as the case may be) or any other method satisfactory to the Commissioner which is consistent with generally accepted principles of computing yield. In the case of acquired obligations, the yield to be produced by such obligations shall be computed as if all acquired obligations comprised a single issue of obligations. Thus, for example, if the governmental unit acquires two blocks of Federal obligations, with different interest rates and maturity periods for each block, the yield on such acquired obligations shall be computed as if one issue of obligations with different interest rates and maturity periods had been acquired. The maturity period of each acquired obligation shall be the period that the governmental unit reasonably expects to hold such obligation.

(ii) If all the governmental or acquired obligations of an issue have a single interest rate (expressed in dollars per $1,000 of face amount of bonds), yield shall be computed using the following 4 steps:

(a) Step (1). Compute the total number of bond years for the issue by multiplying the number of bonds (treating each $1,000 of face amount as one bond for purposes of this computation) of each maturity by the length of the maturity period (expressed in years and fractions thereof) and then adding together the amounts determined for each maturity period.

(b) Step (2). Compute the total interest payable on the issue by multiplying the total number of bond years (as computed in step (1)) by the amount payable, expressed in dollars, as interest on each $1,000 of bonds for 1 year.

(c) Step (3). Compute the net interest in dollars for the issue by adding the amount, in dollars, of any discount to, or by subtracting the amount, in dollars, of any premium from, the total interest payable on the issue.
(d) Step (4). Compute yield by dividing the net interest by the product obtained by multiplying the total number of bond years for the issue by 10.

(iii) If governmental or acquired obligations of an issue have different interest rates (expressed in dollars per $1,000 of face amount of bonds), yield shall be computed using the following 4 steps:

(a) Step (1). Compute the total number of bond years for each group of bonds bearing the same interest rate (treating each $1,000 of face value as one bond for purposes of this computation) in the manner described in step 1 of subdivision (ii) of this subparagraph.

(b) Step (2). Compute the total interest payable on the issue by multiplying the total number of bond years for each group of bonds bearing the same interest rate (as computed in step (1)) by the amount payable, expressed in dollars, as interest on each $1,000 of bonds for 1 year, and then adding together the amounts determined for each group.

(c) Step (3). Compute net interest in the manner described in step (3) of subdivision (ii) of this subparagraph.

(d) Step (4). Compute the yield produced by the issue in the manner described in step (4) of subdivision (ii) of this subparagraph.

(iv) For purposes of this section, the same method of computing yield shall be used to compute the yield to be produced by an issue of governmental obligations and to compute the yield to be produced by acquired obligations acquired with the proceeds of such issue of governmental obligations.

(v) The following example illustrates the provisions of this subparagraph:

Example. Assume an issue of $200,000 ($1,000 per bond) with a stated interest (expressed in dollars per bond) of $50 on bonds maturing in 1, 2, or 3 years, a stated interest of $60 on bonds maturing in 4, 5, 6, or 7 years and a stated interest of $70 on bonds maturing in 8, 9, or 10 years. Assume also that a price of $101 has been bid for the issue. The yield on the issue is determined in accordance with the table below:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Rate</th>
<th>Years to maturity</th>
<th>Bond years at interest rate</th>
<th>Total bond years</th>
<th>Interest rate</th>
<th>×</th>
<th>Interest cost</th>
</tr>
</thead>
<tbody>
<tr>
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<td>1</td>
<td>5,000</td>
<td>50</td>
<td>2</td>
<td>$10,000</td>
</tr>
<tr>
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<td>2</td>
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<td></td>
<td>95</td>
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<tr>
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<td>70</td>
<td>8</td>
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</tr>
<tr>
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<td>70</td>
<td>9</td>
<td>7</td>
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<td>9</td>
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<tr>
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<td>70</td>
<td>10</td>
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<tr>
<td>535</td>
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<td></td>
<td></td>
<td>535</td>
<td>37,450</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td></td>
<td>200,000</td>
<td></td>
<td></td>
<td>79,400</td>
</tr>
</tbody>
</table>

Less premium: 200,000 − 2,000 = 198,000

Divide by: Product of total bond years (200,000), multiplied by 10 = 2,000

Yield (Percent): 79,400/1,250 = 6.32%

(5) Adjusted yield. (i) For purposes of this section, “adjusted yield” shall be computed in accordance with subparagraph (4) of this paragraph, except that in the case of—

(a) Acquired obligations, an amount equal to the sum of the administrative costs reasonably expected to be incurred in purchasing, carrying, and selling or redeeming such obligations shall be treated as a premium on the
purchase price of such acquired obligations.

(b) An issue of governmental obligations, an amount equal to the sum of the reasonably expected administrative costs of issuing, carrying, and repaying such issue of obligations shall be treated as a discount on the selling price of such issue of governmental obligations.

(ii) The provisions of subdivision (1) of this subparagraph may be illustrated by the following examples:

Example (1). State Z issues $15 million of obligations all of which will mature in 10 years. The obligations are sold at $1,000 each (par) to yield 6 percent interest. The adjusted yield produced by such issue of obligations will be determined as follows, assuming the following administrative expenses of issuing, carrying, and repaying such issue of obligations are reasonably expected:

Issuing costs:
- Printing: $12,500
- Financial advisors: $25,000
- Counsel fees: $12,500

Total: $50,000

Carrying costs, paying agent and trustees fees: $10,000

Total administrative costs: $60,000

Bond years (15,000 × 10 years): 150,000

Interest cost per $1,000 bond per year: 60

Total interest: 9,000,000

Discount or premium: 0

Plus adjustments: 60,000

Net interest cost: 9,063,000

Divide by product of bond years (150,000) multiplied by 10: 1,500,000

Adjusted yield: 6.042%

Example (2). State Z uses the net proceeds of the issue of obligations described in example (1) to acquire $14,922,000 of student’s notes at par of $1,000 each under a student loan program. The students’ notes will all mature in 10 years, and all have a stated interest of 7½ percent. Expenses of the program including printing of forms ($5,000), financial advisors’ fees ($11,000), counsel fees ($12,000), trustees’ fees ($5,000), fees for the collecting agents and various banks which administer the loans ($100,000), advertising expenses ($10,000), credit reference checks ($20,000), and general office overhead ($5,000). Of the expenses listed in the preceding sentence, only those indicated on the following table constitute adjustments to yield in order to determine the adjusted yield to be produced by the students’ notes:

Purchasing costs:
- Printing forms: $5,000
- Financial advisors: $11,000
- Counsel fees: $12,000

Total: $28,000

Carrying costs, trustees fees: $5,000

Total administrative costs: $33,000

Bond years (14,922×10 years): 149,220

Interest receivable per $1,000 note per year: 75

Total interest receivable: 11,191,500

Discount or premium: 0

Minus adjustments: 33,000

Net interest receivable: 11,158,500

Divide by product of bond years (149,220) multiplied by 10: 1,492,200

Adjusted yield: 7.478%

(b) Rule with respect to certain governmental programs—(1) General rule. Subject to the limitations of subparagraph (3) of this paragraph, any obligations which are part of an issue of governmental obligations the proceeds of which are reasonably expected to be used to finance certain governmental programs (described in subparagraph (2) of this paragraph) are not arbitrage obligations.

(2) Governmental programs. A governmental program is described in this subparagraph if—

(i) The program involves the acquisition of acquired purpose obligations to carry out the purposes of such program (which obligations, for purposes of this paragraph, are referred to as “acquired program obligations”);

(ii) At least 90 percent of all such acquired program obligations, by amount of cost outstanding, are evidences of loans to a substantial number of persons representing the general public, loans to exempt persons within the meaning of section 103(c)(3), or loans to provide housing and related facilities, or any combination of the foregoing;

(iii) At least 90 percent of all of the amounts received by the governmental unit with respect to acquired program obligations shall be used for one or more of the following purposes: To pay the principal or interest or otherwise to service the debt on governmental obligations relating to the governmental program; to reimburse the governmental unit, or to pay, for administrative costs of issuing such governmental obligations; to reimburse the governmental unit, or to pay, for administrative and other costs and anticipated future losses directly related
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to the program financed by such governmental obligations: to make additional loans for the same general purposes specified in such programs; or to redeem and retire governmental obligations at the next earliest possible date of redemption; and

(iv) Requires that any person (or any related person, as defined in section 103(c)(6)(C)) from whom the governmental unit may, under the program, acquire acquired program obligations shall not, pursuant to an arrangement, formal or informal, purchase the governmental obligations in an acquired program obligations to be acquired from such person by the governmental unit.

(3) Limitation. The provisions of subparagraph (1) of this paragraph shall apply only if it is reasonably expected that—

(i) A major portion of the proceeds of such issue of governmental obligations, including proceeds represented by repayments of principal and interest received by the governmental unit with respect to acquired program obligations, shall not be invested for more than a temporary period (within the meaning of section 103(d)(4)(A)), in acquired obligations (other than acquired program obligations) which produce a materially higher yield than the yield produced over the term of the issue by such governmental obligations, and

(ii) The adjusted yield (computed in accordance with paragraphs (a) (4) and (5) of this section) to be produced by acquired program obligations shall not exceed the adjusted yield (computed in accordance with paragraphs (a) (4) and (5) of this section) to be produced by such issue of governmental obligations by more than 1 1/2 percentage points, or

(b) Where the difference in the adjusted yields described in subdivision (ii)(a) of this subparagraph is expected to exceed 1 1/2 percentage points, the amount so to be obtained as a result of the difference in such adjusted yields shall not exceed the amount necessary to pay expenses (including losses resulting from bad debts) reasonably expected to be incurred as a direct result of administering the program to be financed with the proceeds of such issue of governmental obligations, to the extent that such amounts are not payable with funds appropriated from other sources.

(4) Examples. The following examples illustrate governmental programs described in subparagraph (2) of this paragraph:

Example (1). State A issues obligations the proceeds of which are to be used to purchase certain home mortgage notes from commercial banks. The purpose of the governmental program is to encourage the construction of low income residential housing by creating a secondary market for mortgage notes and thereby increasing the availability of mortgage money for low income housing. The legislation provides that the adjusted yield produced by the mortgage notes to be acquired will not exceed the adjusted yield produced by such issue of obligations by more than 1 1/2 percentage points. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) To service the debt on the governmental obligations, (2) to retire such obligations at their earliest possible date of redemption, (3) to purchase additional mortgage notes. The governmental program is one which is described in subparagraph (2) of this paragraph and the governmental obligations are not arbitrage bonds.

Example (2). State B issues obligations the proceeds of which are to be used to make loans directly to students and to purchase from commercial banks promissory notes made by students as the result of loans made to them by such banks. The legislation authorizing the student loan program provides that the purpose of the program is to enable financially disadvantaged students to continue their studies. The legislation also provides that purchases will be made from banks only where such banks agree that an amount at least equal to the purchase price will be devoted to new or additional student loans. It is reasonably expected that the difference in adjusted yields between the issue of governmental obligations by State B and the students’ notes will be 1 1/2 percentage points. It is also reasonably expected that the amount necessary to pay the expenses (other than expenses taken into account in computing adjusted yield) enumerated in subparagraph (3)(i)(b) of this paragraph, directly incurred as a result of administering State B’s student loan program, such as, for example, losses resulting from bad debts, insurance costs, bookkeeping expenses, advertising expenses, credit reference checks, appraisals, title searches, general office overhead, service fees for collecting agents and various banks which administer the loans, and salaries of employees not paid from other sources, will not require a difference in
adjusted yields in excess of 1\% percentage points. The governmental program is one which is described in subparagraph (2) of this paragraph. Since, however, the difference in adjusted yields produced by the students' notes and the issue of State B obligations is reasonably expected to exceed 1\% percentage points, and since State B cannot show that 1\% percentage points is necessary to cover such expenses, the provisions of subparagraph (1) of this paragraph shall not apply to the issue of State B obligations. If, however, State B reasonably expected that 1\% percentage points would be necessary to cover such expenses, the provisions of subparagraph (1) of this paragraph would apply and the governmental obligations would not be arbitrage bonds.

Example (3). Authority C issues obligations the proceeds of which are to be used to purchase land to be sold to veterans. The governmental unit will receive purchase-money mortgage notes secured by mortgages on the land from the veterans in return for such land. The purpose of the program is to enable veterans to acquire land at reduced cost. The adjusted yield produced by the mortgage notes is not reasonably expected to exceed the adjusted yield produced by the issue of obligations issued by Authority C by more than 1\% percentage points. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) To pay the administrative costs directly related to the governmental obligations, (3) to retire such governmental obligations at their earliest possible call date, (4) to purchase additional land to be sold to veterans. The governmental program is one which is described in subparagraph (2) of this paragraph and the governmental obligations are not arbitrage bonds.

(c) Effective date. The provisions of this section will apply with respect to obligations issued after October 9, 1969, and before final regulations are promulgated.


§§ 13.5–13.9 [Reserved]

§ 13.10 Distribution of money in lieu of fractional shares.

(a) In general. (1) Under the general rule of section 305, as amended by section 421(a) of the Tax Reform Act of 1969, gross income does not include the amount of any distribution of the stock (or rights to acquire the stock) of a corporation made by such corporation to its shareholders with respect to its stock. Under an exception to the general rule, a distribution by a corporation of its stock or rights to acquire its stock is treated as a distribution of property to which section 301 applies if the distribution (or a series of distributions of which such distribution is one) has the result of (i) the receipt of money or other property by some shareholders, and (ii) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Also, the Secretary or his delegate is directed to prescribe regulations under which a redemption which is treated as a distribution to which section 301 applies, or any other transaction having a similar effect on the interest of any shareholder, shall be treated as a distribution with respect to any shareholder whose proportionate interest in the assets or earnings and profits of the corporation is increased by such redemption or transaction.

(2) The general rule, and not the exception, applies in the case where cash is distributed in lieu of fractional shares to which the shareholders would otherwise be entitled, provided the purpose in distributing the cash is to save the distributing corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares (or scrip representing fractional shares), or issuing full shares representing the sum of fractional shares, and not to give any particular group of shareholders an increased interest in the assets and earnings and profits of the corporation.

(b) Illustration. The application of paragraph (a) of this section may be illustrated by the following example:

Example. Corporation X is a large corporation whose stock is widely held by the public, no one shareholder owning more than 10 percent of the outstanding stock. The stock is listed on a recognized exchange and is currently selling at less than $75 per share. During the year the corporation pays a 5 percent stock dividend. Cash is paid to each shareholder in lieu of a fractional share to which he would otherwise be entitled. The distribution of cash in lieu of fractional shares is not intended to give any particular group of